IN THE

# Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1665

CHESTNUTT CORPORATION, GEORGE A. CHESTNUTT, JR.,
ARNOLD JOHN CURRIER, WARREN K. GREENE
and STANLEY L. SABEL,

*Petitioners,*

v.

ROSALIND FOGEL and GERALD FOGEL,

and

AMERICAN INVESTORS FUND, INC.,

*Respondents.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Chestnutt Corporation (a Connecticut corporation), George A. Chestnutt, Jr., Arnold John Currier, Warren K. Greene, and Stanley L. Sabel, defendants in this action, pray that a Writ of Certiorari issue to review the decision of the United States Court of Appeals for the Second Circuit which reversed the decision of the District Court for the Southern District of New York and remanded the case for determination of damages.

## Opinions Below

The decision of the District Court is reported in 383 F. Supp. 914. The opinion of the Court of Appeals is unofficially reported in ¶ 95,393 CCH, Fed. Sec. L. Rep. and has not yet been officially reported. Such opinions are set forth in the appendix (A. 5, A. 33).*

## Jurisdiction

Judgment of the Court of Appeals was dated and entered December 30, 1975, and petitioners' timely Petition for Rehearing (with Suggestion of En Banc) was denied March 17, 1976 (A. 1-4). Jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## Questions Presented for Review

Where full compliance is admitted with all applicable statutes and regulations and it was found after trial that there had been full disclosure of stock brokerage practices of a no-load mutual fund (A. 21)—

Whether retroactive, implied liability for money damage can be imposed on a registered investment counsel and adviser by displacing and substituting for this Court's high standard for investment counselors and advisers of not engaging in conflicting "brokerage" (*SEC* v. *Capital Gains Research Bureau Inc.*, 375 U.S. 180, 190 (1963)) conjectural "remarks" (A. 35) voicing a contrary and transient administrative whim, for which the Court of Appeals imposed "harsh" (A. 82) liability for failure to engage in conflicts of interest including joining a regional

* "A. —" is appendix hereto; "Tr. —" means trial transcript; "—a" means appendix below.



stock exchange. This question necessarily embraces and includes:

(1) Whether a victim of cartels was required to attempt to join them, and if so, could have joined without deceit?

(2) Whether federal common law "waste" will lie for failure to enter a new and conflicting business, or whether defendants could rely upon existing statute law and regulation as provided in §38(c) of the Investment Company Act of 1940?

(3) Whether investment advice and counselling is essentially equivalent to brokerage as held by the Court of Appeals?

(4) Whether old or supervening law prevents plaintiffs from showing either fact of damage or liability under §36 of the Investment Company Act of 1940 and §6 of the Securities Acts Amendments of 1975?

## Statutes Involved

Set forth in the Appendix are applicable provisions of

Investment Company Act of 1940 §§17, 36(a), 36(b), 38(c) (15 U.S.C. 80a, et seq.; 54 Stat. 815 et seq., as amended)

Securities Acts Amendments of 1975 (Pub. L. 94-29) (Section 6)

## Statement of the Case

The Court of Appeals, reversing the trial court, held defendants liable for money damages for failure to join a regional stock exchange ("PBW"); for failure to join the National Association of Securities Dealers; and for failure through self-dealing with a captive account to generate hypothetical profits, Some of which might spill over to the
l.c

captive customer, which would thereby receive a preference over the general public through a rake-off called "recapture".

**A "No-Load" Fund**

Defendant George A. Chestnutt, Jr. ("Chestnutt") has been in the investment counselling business since 1946, both managing hundreds of individual accounts and publishing an advisory service to subscribers called "American Investors Service" (Tr. 108-116). His entities have always been registered investment counsel and advisers under the Investment Advisers Act of 1940 (15 U.S.C. 80b, et seq.).

In 1957 American Investors Fund, Inc. (the Fund), a New York corporation, was formed and issued its first prospectus in 1958. The Fund's first million dollars of shares were sold to subscribers to "American Investors Service" (Tr. 114) published by a partnership, American Investors Company, later becoming American Investors Corporation, then reincorporated in Connecticut as Chestnutt Corporation ("the Adviser") in 1966.

The Fund is a "no-load" fund under § 10(d) of The Investment Company Act of 1940 (the Act).* It initially



paid a flat 1% advisory fee to the Adviser, which was the rate in effect at the time plaintiffs made their first purchases in January 1963, and which rate was voluntarily reduced below the statutory level for no-load funds in 1964 (Stip., 27-28a), after the fund had reached about the $12 million level. That year, 1963, this Court decided *SEC v. Capital Gains Research Bureau, Inc., supra.*

The Fund is sold by direct mail and advertising (Tr. 137-139). The Adviser used mailing lists and advertisements in financial papers and certain New York and Los Angeles newspapers (Tr. 139). The Adviser "keyed" its advertising in order to determine its effectiveness and knew from correspondence that the Fund's reputation spread by word of mouth, which the Adviser referred to as "radiation" in its contemporaneous sales records, abbreviated "rad." (Tr. 140).

About 40% of the Fund's sales were attributed directly to advertising, "known ads that we put in . . .", "keyed" for advertising response and about 45% to 50% to "radiation". Chestnutt attributed some of the "radiation" to advertis-

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* 15 U.S.C. 80a-10(d), including the amendment effective December 15, 1971 substituting words "interested persons" for "affiliated persons" provides:

"10(d) Notwithstanding subsections (a) and (b)(2) of this section, a registered investment company may have a board of directors all the members of which, except one, are interested persons of the investment adviser of such company, or are officers or employees of such company, if—

(1) such investment company is an open-end company;

(2) such investment adviser is registered under title II of this Act and is engaged principally in the business of rendering investment supervisory services as defined in title II;

(3) no sales load is charged on securities issued by such investment company;

(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

(8) such investment company has only one class of securities outstanding, each unit of which has equal voting rights with every other unit.

ing, although it is not measurable. In a falling market, advertisements were predictable failures (Tr. 141).

It took about 5 years for the Fund to attain total assets of $5 million (Ex. E, the 1973 Semiannual Report containing a chart), at which level newspapers first published daily quotations.

The Securities and Exchange Commission has taken note of the special niche of "no-load" funds in "Public Policy Implications of Investment Company Growth" (H.R. No. 2337, 89th Cong. 2nd Sess. 1966, Ex. 4, p. 53; Tr. 126) stating:

> "From the small investors point of view the sales load is by far the principal cost of a mutual fund investment. Most mutual fund investors are small investors, and the 8.5% sales load they normally pay is—assuming that the net asset value of the Fund's shares does not change—almost 19 times the prorated share of the customary annual advisory fee of ½ of 1%."

Plaintiff Rosalind Fogel attended college (Ex. R, p. 5). Her husband had four years of accounting education (Ex. R, p. 16), and they carefully reviewed the records of investment companies' performance and deliberately commenced buying Fund shares (Ex. R, pp. 9, 11) in 1963 because it was a no-load fund and she would not have to pay a 9.3% load or commission, as she had in her prior purchase of a different fund. She testified:

> "We were shopping for something that would save us a commission fee. It was a no-load fund and appealed to us because of the performance record." *

(Ex. R, p. 7, see also pp. 15-16).

* The Fund's investment record for its entire history 1958 through 1974 appreciated exactly three times as much as the Dow Jones Industrial Average, or by 116.5% versus 38.4% (including reinvestment of capital gains but excluding income distribution).



Notwithstanding the Fund's "performance record", when plaintiffs commenced buying in January 1963 (Ans. ¶ 2, 15a) the Fund's total net assets were only $6.6 million (Ex. E). Plaintiffs made a number of cash investments including one of $200 on January 10, 1969, six months after commencing this suit and two years after commencing a first suit (67 Civ. 60), now dismissed.

The SEC noted (Ex. 4, p. 52) that approximately 60 no-load funds were only a little over one-twentieth, or about 5%, of the mutual fund industry (Ex. 4, p. 52, 59), and described the distinctive industry pattern which obtained with the no-load funds under Section 10 (d) of the Act (at p. 59):

> "No-load shares are sold by the fund itself with the aid of its investment adviser. The absence of a sales load precludes the development of the complex distribution systems and the exertion of the vigorous direct selling efforts characteristic of the load funds. No-load funds employ no salesmen. However, they and their advisers stimulate share sales by advertisements in newspapers and periodicals, stating that the fund is a no-load fund and inviting requests for copies of its prospectus. And some no-load funds encourage brokers to recommend their shares to prospective investors by directing their portfolio brokerage business to those brokers who promote[*] the sale of their shares. Other significant sources of business are the advisers general nonfund advisory clientele, recommendations by lawyers, bankers and others on whom people rely for investment advice; articles in the financial press; the reputation of a

* N.B.: "promote", rather than "sell".

particular fund for investment expertise; and new investment by existing shareholders.

"These methods of obtaining business have been considerably less effective than the load funds' far more vigorous, personalized selling drives. Hence the no-load funds have only a small share of total mutual fund assets and shareholder accounts."

Since the Fund is a no-load fund, there was never any legal or economic function to be performed by an "underwriter" or "dealer" in what the SEC calls a "complex distribution system".

By contrast, an underwriter (or "dealer-distributor") is an integral, functioning link in the sale of load funds. The underwriter has both legal and economic functions in that the underwriter "buys" shares from a fund at wholesale and "sells" shares to other dealers, or else sells to the public directly through the underwriter's captive sales force, thereby avoiding having to split the "load" or commission with retail dealers or brokers.

These methods of doing business, amply described in the numerous prospectuses of "load" funds introduced by plaintiffs' need no elaboration. Many load funds are parts of huge conglomerates (for example, the $6 billion dollar "IDS" complex, Stip. 29a). Many have been formed by New York Stock Exchange brokerage houses, at least in part to stimulate commission business on the Exchange as well as to obtain up to 9.3% of the small investors' funds as a load or commission.

The SEC (Ex. 4, also at p. 53) further stated:

"The $85 sales load on a $1,000 purchase of mutual fund shares from which an 8.5 percent load is deducted is 9.3 percent of the $915 that actually goes to the



fund and would be described as a 9.3 percent charge, if mutual fund sales loads were computed in the way in which selling commissions and discounts are usually computed in the exchange and over-the-counter markets." (footnotes omitted)

**Technical Analysis**

The Adviser's advice is based on "technical analysis" (Tr. 110-115). About 95% of the selection and timing of the transactions is derived by in-house technical research (Tr. 116-123). Nothing is derived from brokerage firms (Tr. 121), but brokers are on the phone with suggestions, and every day's mail contains studies which the brokers submit to stimulate business.

The technical analysis is minutely described in all the prospectuses (Ex. 5-15) of the Fund. It is sufficient here merely to note that the Adviser keeps daily statistical records on approximately 1300 stocks, divided into 70 industry groups, and that the data are fed into the predetermined program of a computer, which ranks such stocks in percentile groupings which shows their *"relative"* market strength, both by individual stocks and by industry groups. The Adviser publishes weekly information with respect to 1,000 stocks of these 1,300, and with respect to the 70 industry groups therein.

An example of the weekly report is Ex. D. Chestnutt's pamphlet "Stock Market Analysis Facts and Principles" is Ex. N. Chestnutt described technical analysis, Tr. 110-123.

**Small Shareholdings, Effect of "Load", Redemptions, Sales**

As the SEC pointed out (*supra,* p. 6) "most mutual fund investors are small investors . . .". That is true of this

Fund,* where the average shareholding of the Fund is about $2,000 (Tr. 126).

Reference to financial statements in the funds prospectuses (Ex. 5-15), shows for each year under "Statement Of Changes in Net Assets" both the proceeds from sales of Fund shares and the pay-out on redemption of Fund shares. At the end of 1962, and immediately prior to the plaintiffs' first purchase, the total net assets of the Fund were only $6.6 million. Nevertheless, for the 10 years 1962 through 1972 the Fund paid redemptions aggregating $363 million, or 55 times the Fund's total net assets at the beginning of the period.**

Thus, plaintiffs would have had no opportunity to invest, or continue investments, in a no-load fund, which would have been 55 times its 1962 height under water after 10 years, were it not for total sales of additional shares of $650 million in that 1963 through 1972 period.

Accordingly, new sales are imperative if the Fund, or its industry, are to survive as a medium for small investors.

Sales to accounts averaging $2,000 in size, at the customary "load" of 9.3% of invested capital, would have amounted to approximately $60 million paid to underwriters and distributors (and divided by them among salesmen and other dealers). However, since this Fund is a no-load fund, its shareholders saved that $60 million which was put to work as their investment.

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* In 1970 the Fund for the first time established a $400 minimum initial subscription, with subsequent investments of $10. (Ex. 12)

** Redemptions of $27.7 million and $14.4 million in 1973 and 1974 resulted in net redemptions, after sales of new shares, of $17.3 million and $4.4 million for such periods, respectively.



**Required Brokerage at Fixed Commission Rates**

The SEC stated (Ex. 4, p. 53):

> "Injections of new capital into and withdrawal of old capital from a mutual fund lead to purchases and sales of portfolio securities that entail brokerage costs".

This truism was followed on page 54 with:

> "Since the cost of purchasing a round lot of a listed security, which is usually around 1 percent of the purchase price, must be paid by sellers as well as by buyers, the total cost of the purchase and subsequent sales of a listed security, assuming no change in the security's market price, is normally about 2 percent (1 percent when buying and a second 1 percent when selling) of the security's price".

Thus, a billion dollars in-and-out, turned over only once in a decade, would result at old (fixed) rates in brokerage commissions of $20 million on portfolio transactions of that billion dollars, sanctified by the SEC and now called "excess commissions".

The Fund could not save any money at the fixed rates. Its brokerage practices were described in its proxy statements and prospectuses (Ex. 5-15), and, as an example, the material information on brokerage from the 1969 proxy statement (Ex. 19) for approval of the advisory agreement and election of directors, is set forth in full:

> "Brokerage Commissions
>
> "The Fund's investment policies have resulted in a higher than average rate of portfolio turnover, 39.5% in 1966, 64.0% in 1967, and 81.9% in 1968, exclusive of all U. S. Government securities and all other securities

whose maturities at the time of acquisition were one year or less. The Fund places orders for transactions in portfolio securities with brokers or dealers providing the most favorable prices and executions available. Speed and accuracy in obtaining market quotations, promptness in execution of orders at minimum commission rates, and prompt reporting of executions are absolutely essential. Among such brokers and dealers, those who have provided helpful information to the Fund, or have assisted in the sale of Fund shares, are given preference (without agreement so to do) in allocating brokerage business, but not at any sacrifice in price or execution. Whether or not such preference were given, the Fund would have to pay the same amount of commissions.

"Helpful information obtained from brokerage sources involves quick, accurate quotations and data as to the size of the market; data on money statistics, earnings projections, dividend prospects; probable sellouts, mergers, consolidations, and liquidations; general tape action, with volume of shares, blocks recently traded or to be traded, who the buyers and sellers are believed to be, and other information as to the state of the market at a particular moment.

"Brokerage commissions of $551,668 were charged to the Fund on purchases and sales of the Fund's portfolio securities in 1966, $1,995,087 in 1967, and $3,122,160 in 1968. Of such amounts the Fund allocated approximately $261,913 in 1966, $935,966 in 1967, and $2,022,457 in 1968, to brokers who provided helpful information, and approximately $289,755 in 1966, $1,059,121 in 1967, and $1,099,703 in 1968, in connection with the sale of Fund shares. Included in the above amounts allocated for helpful information and sale of Fund shares are brokerage commissions of $33,435 in



1966, $23,936 in 1967, and $44,537 in 1968, to Vilas & Hickey (the wife of a registered representative of which firm owned 6.3% of the voting and other securities of the adviser). Prior to December 5, 1968, when the practice was discontinued in the industry, the Fund in some instances directed the broker who executed orders to give up to another broker a portion of his commission in accordance with stock exchange rules and regulations. The total amount of such give-ups during the last two fiscal years was $326,120 in 1967 and $633,095 in 1968. Since December 5, 1968, the Fund has discontinued directing give-ups but has continued giving preference in the allocation of brokerage business to such brokers and dealers who have provided helpful information or who have assisted in the sale of Fund shares. Following are tabulations showing for 1967 and 1968 the ten brokers who received the greatest amount of brokerage commissions by virtue of direct or indirect participation in the purchase or sale of portfolio securities for the Fund.

1967

| Broker | Gross Commissions | Give-ups received | Give-ups paid |
|---|---|---|---|
| "Hayden Stone & Co. | $232,128 | $ 3,560 | $ 22,885 |
| Jesup & Lamont | 193,652 | — | 50,742 |
| Clark, Dodge & Co., Inc. | 122,829 | 115 | 15,394 |
| C. E. Unterberg Towbin | 88,586 | — | — |
| Tucker, Anthony & R. L. Day | 83,645 | 350 | — |
| E. F. Hutton Company, Inc. | 79,098 | 635 | 1,457 |
| Bateman Eichler, Hill Richards | 19,018 | 57,915 | — |
| Bear Stearns | 111,697 | 224 | 36,245 |
| McDonnell & Co. | 64,772 | 1,125 | — |
| G. A. Saxton | 85,658 | — | 23,560 |

1968

| Broker | Gross Commissions | Give-ups received | Give-ups paid |
|---|---|---|---|
| "Jesup & Lamont | $311,067 | — | $110,210 |
| Pershing & Co. | 188,295 | — | 123,060 |
| Merrill Lynch Pierce Fenner & Smith Inc. | 178,506 | $ 1,495 | — |
| Hayden Stone, Inc. | 174,763 | 14,985 | 28,598 |
| G. A. Saxton & Co., Inc. | 170,356 | — | 78,892 |
| Bear Stearns | 140,949 | 1,000 | 35,405 |
| Thomson & McKinnon, Inc. | 126,833 | — | 31,905 |
| Clark, Dodge & Co., Inc. | 103,968 | — | 7,985 |
| Sidney A. Siegel & Co., Inc. | 99,949 | — | — |
| Model Roland | 98,624 | — | 17,445 |

"Without knowing what the results would have been absent the helpful information, the Fund knows of no way to determine the approximate value of helpful information obtained. Helpful economic information relating to particular investment situations, received by the Fund, is generally unsolicited and offered by a broker to stimulate business. It is the practice of the Fund upon receiving such helpful information from brokerage sources to refer such information to its investment adviser, for verification and opinion as to validity, accuracy, and for further research and recommendation as to the desirability of acting upon such



information. This involves work by the adviser with related costs, and to the extent such information can be utilized, such information can aid the Adviser in achieving better investment performance for the Fund. The information itself, for which the Fund allocated approximately $546 in 1966, $7,664 in 1967, and $7,615 in 1968, aided the adviser in performing its obligations under its advisory contract with the Fund as well as benefiting the Fund."

The trial Court found:

"The use of reciprocals and give-ups was fully disclosed in the prospectuses of the Fund" (A. 21).

This decade of full disclosure bore in each year the individual signatures of all directors, whose oral testimony included the following.

## Concerning the "Unaffiliated" and "Disinterested" Directors

At the time this action was commenced, 4 of the 7 Fund Directors were "unaffiliated." (Ex. 11).

While under Section 10(d) of the Act, the Fund could have had only one director who was not an "affiliated person" (and later after December 15, 1971 an "interested person")—since this no-load fund did not charge an advisory fee in excess of one per cent—the trial Court found that at all times there had been either three or four independent directors (A. 10). Director Currier who joined the Board in 1962 was an "unaffiliated director", both before and after joining the Board, but later acquired privately from an individual about 2% of the Adviser's stock. Under the 1970 amendments (effective December 15, 1971), creating a new

definition of "interested person", Currier became an "interested person" thereafter, although remaining an "unaffiliated" director.

**A. Director Richard Radcliffe**

Radcliffe joined the Board in 1958 when the Fund was about $1 million in size.

His entire deposition, although taken by plaintiffs, was introduced in evidence by defendants as Exhibit Q. He also testified in person (Tr. 367-388). Plaintiff's counsel called him the "most sophisticated" of the unaffiliated directors (Ex. Q, pp. 1-11) for the good reason that following Radcliffe's graduation from Yale, he was from 1948 to 1950 at the American Institute of Economic Research in Great Barrington, Massachusetts; from 1950 through 1953 with White, Weld & Co. in the investment advisory department; from 1953 to 1965 was a managing partner of A. W. Jones & Co., the well publicized and highly successful partnership hedge fund; and from 1965 to the present a managing partner of Fairfield Partners, another hedge fund. Years of most esoteric and broad experience—25 of them—never led Radcliffe to recommend that either A. W. Jones & Co. or Fairfield Partners or American Investors Fund, Inc. have any affiliation with a broker. He was familiar with the efforts commencing in 1965 of certain load funds, having a functioning "underwriter-distributor", to participate through NASD membership in recapture, the hypothetical profits of which might be used to reduce advisory fees (Ex. Q, pp. 23-28).*

* It is stipulated in the pretrial order (29-30a) that Waddell & Reed, Inc., a $2.6 billion conglomerate, in 1965 apparently agreed to reduce the advisory fees by 50% of a brokerage subsidiary's *profits*, hopefully to be derived from running brokerage through different markets of regional exchanges for the purpose of "recapture". This self-dealing program resulted in a death sentence and consent order of extermination of Kansas City Securities Corp., which Waddell & Reed had formed. (SEC Releases Nos. 40-8556, 34-11072 and 428 under The Investment Advisers Act of 1940, all dated October 24, 1974).



Radcliffe did not believe that this experiment in self-dealing was applicable to the Fund

> "Because they are a no-load fund. They have no NASD member, broker-dealer, selling the Fund's shares and for that reason would not qualify for membership on any exchange that I know of " (Ex. Q, pp. 30-31).

At pp. 33-34 of Ex. Q, plaintiffs' counsel made it entirely clear that he was talking about a "paper company"; a "shell" that was not in the brokerage business; a "dummy" that would not be in the brokerage business and would be operating "solely for the purpose of receiving give-ups", doing no business for the public and would not have sold investment company shares to the public.

At pp. 44-46 of Ex. Q Radcliffe made his views clear that he would have been "opposed" to any such course, that

> "would have led the management company into a field on which they had no expertise and it would have been a diversion of their efforts and would have required that they set up some kind of a brokerage business" (p. 44).

And again, and going to the heart of the matter,

> "I think it would have caused them to make some different type of decisions than they were making, in the manner that first of all, there would be a question of the very conflict of whether you allocate commissions to yourself or whether you allocate commissions to brokers for executing orders and providing you with information and assisting in the sale of funds" (p. 46).

Racliffe and all directors were, of course, completely familiar with the prospectuses and proxy statements, receiving proofs prior to directors' meetings and discussing the references therein to the Fund's brokerage practices (pp. 47-49). Radcliffe repeated his opinion that Chestnutt Corporation should stick to managing the Fund and not get into the brokerage business; that American Investors differed from other types of funds; that there was a "conflict of interests" leading to poor execution if there were an inducement to trade on the thin Pacific Coast Exchange and his own view that

> "I think there is a real risk that a Fund recaptures commissions is going to generate commissions, simply for the purpose of recapturing them, which means the investment decision is tainted by the desire to earn some money out of commissions" (pp. 57-58).

Radcliffe made it absolutely crystal clear and in the light of his experience:

> "I have always been opposed to the combination of brokerage and investment managers, and I think the two areas should be separated, that brokers should not be in the investment management business and investment managers shouldn't be in the brokerage business" (p. 59).

While Radcliffe had investigated becoming a broker, he had never sought it (p. 59).

Radcliffe's trial testimony (Tr. 367-387) is equally to the point. His background, personal placing of brokerage orders, both on the long and the short side for hedge funds and his failure to recommend brokerage activity for A. W. Jones & Co., Fairfield Partners or the Fund are repeated (Tr. 367-372). With respect to the prospectus language



of two other no-load funds, T. Rowe Price Growth Stock Fund and T. Rowe Price New Era Fund (Exhibits T and T-1), he was asked specifically whether the language in such prospectuses with respect to conflict of interest and diversion of energies of that adviser accorded with his views both presently and when he was a member of the Fund's Board. He was in emphatic agreement that those exhibits, disclosing management of well over a billion dollars and several times the size of American Investors Fund, Inc., that it would be improvident to participate in the brokerage business (Tr. 375-376).

Radcliffe noted the difference between load funds having an underwriter and no-load funds and in his judgment as a director, it was necessary for the Fund and its Adviser to promote the sale of Fund shares (Tr. 380-381). And he did know what Waddell & Reed was up to, and said ". . . it's not what I think American Investors should have been doing" (Tr. 378).

One such "unaffiliated" and "disinterested" director, all that is required of a no-load fund under § 10(d)(1) of the Act, "sophisticated", specialized, and experienced in the very field of portfolio transactions and who had served for 11 years while the Fund grew from $1 million to over $300 million, is quite sufficient to defeat plaintiffs' claim. The insiders could not have fooled him if they tried.

**B. Director Eugene Ulrich**

But the newest "disinterested" director, as well as the other directors, was to say the least well informed, and indeed was as peculiarly well qualified as Radcliffe.

Ulrich, with a Masters Degree from the Tuck School, in 13 years with Arthur Andersen & Co. audited other investment companies and investment advisers and com-

mon trust funds of Bankers Trust and Morgan Guaranty. He had been internal auditor of Sinclair Oil, Controller of B. P. Oil Corporation and was Assistant Controller of American Airlines (Tr. 331-334).

Coming on the Board in 1971, Ulrich never recommended that the adviser engage in brokerage; considered it a "conflict of interest" for the adviser even to be "connected with" brokerage or "doing brokerage business" (Tr. 336). Moreover, on cross-examination and apart from policy judgments, this director of varied experience in the investment company field concluded ". . . I think the cost of maintaining a brokerage business would probably exceed the benefits" (Tr. 337).

**C. Director William F. May**

Unaffiliated director May, who left the Board in 1965 after a couple of years because of a conflict (Tr. 358) upon joining the Bankers Trust Board, is a chemical engineer, holder of an Advanced Management degree from Harvard Business School, Chairman and Chief Executive of American Can Company, director of Johns-Mansville and the New York Times, and Trustee of Lincoln Center, University of Rochester, Dartmouth and Brooklyn Polytechnic Institute. He never recommended the formation of a brokerage firm (Tr. 361), just as he never sought to have his own corporation perform all types of services. Mr. May's service coincided with the growth of the Fund from $6.6 million at the end of 1962 to about $50 million, and with the reduction in the advisory fee from the flat 1% to the decreasing sliding scale described in the stipulation (27-28a) and prospectuses, Exs. 6, 7, and 8.

**D. Director Frank Fowler**

Plaintiffs took the deposition (Ex. P) of "disinterested" director Fowler, but did not offer it in evidence, and



insisted that this "defendant" be produced, while neglecting to advise the Court the "defendant" was never served (Tr. 345). When Fowler was produced at the next session of the trial some days later, plaintiffs declined to examine in open Court, presumably as a device to sidetrack oral examination of Radcliffe. Fowler, an independent businessman and engineer and director since 1962 was opposed to any involvement in brokerage (Ex. P, especially pp. 35-37).

**E. Director Frank Veeder**

Named but unserved defendant director Veeder died several months before trial and was never deposed.

**F. Director John Currier**

Currier, likewise having a Masters Degree from Harvard Business School, and president of a major division of Genesco, became a director in 1962 and thereafter acquired a less than 2% stock interest in the adviser. He continues to be an "unaffiliated" director, and during the period until December 1968, when "give-ups" were abolished, qualified to be the sole "unaffiliated" director, under Section 10(d) of the Act, becoming an "interested person" only after the 1970 amendments effective 1971 (Tr. 317-319).

He was opposed even to the "possibility" of having the adviser participate in brokerage (Tr. 322), and recognized the inherent conflicts and diversion of effort.

## The Position of the "Affiliated Directors" and "Interested Persons"

**A. Director George A. Chestnutt, Jr.**

Chestnutt had always been an investment counsellor and an investment adviser. He had never been a broker or

dealer. His opposition to being in the brokerage business is expressed throughout his testimony but can be noted especially at Tr. 229 to 230 on cross examination, as follows:

"Q. Did counsel advise you that it was illegal? A. They have advised me against it because it was fraught with self-dealing, with temptations of various sorts, and as I have said before, the expression Mr. Sabel used, shoemaker stick to your last.

"It is an old expression and Mr. Sabel has used it repeatedly in telling me to stay out of the brokerage business and stick to the thing I know best, which is analyzing the market."

"Q. If you form an affiliate that merely receives commissions and pays them back to the fund, where is the self-dealing? A. I didn't know that it was possible to do that and it never occurred to me until you brought it up."

"Q. Did you ever make any inquiry of the NASD or of the Philadelphia Exchange which it was possible? A. NASD stands for National Association of Securities Dealers. That means that the members are securities dealers; not just holding out a place for a mail drop for checks to fall into. It didn't occur to me that it was a national association of check drop artists."

**B. Director Warren K. Greene**

Greene, who had spent some five years with First Boston Corporation and had received a Masters Degree in finance (Tr. 238) and had had intensive training and experience in the various departments of that firm (Tr. 239-241), was opposed to any entry into the brokerage or underwriting business by the adviser (Tr. 295-299). On the basis of his experience, and the fact that the Fund was a "no-load fund", he was asked on cross examination whether the adviser was eligible to be a member of the NASD, and he repeated what he had said on deposition, namely that since there was no dealer organization or underwriting affiliation there was no need to be either a broker or a broker-dealer (Tr. 300). Then the Court stated:



"I am not questioning the wisdom or the prudence, I am just questioning your eligibility, and you testified, just read, that you weren't eligible, and I take it from what you just this moment told me you weren't eligible because you didn't meet the definition of broker or broker-dealer; is that it?"

The Witness: "That's right, sir."

The foolhardiness and the conflict of interest in creating any functioning brokerage affiliate for dealing on regional exchanges (as distinguished from a shell or a sham) was made crystal clear by the uncontradicted testimony (Tr. 311-313) that a proper allocation of expenses, including space, salaries of officers, salaries of traders and other overhead matters should be about \$150,000 to \$200,000 per year. Thus, if the Adviser had formed a brokerage affiliate to funnel and increase brokerage on the thin markets of regional exchanges, the amount of business done on such regional exchanges would have had to be vastly increased before there could have been any "net profits" to share with the Fund upon some formula, and in the meantime the Adviser could have unburdened itself of substantial annual expenses, to be paid for by Fund brokerage business placed on regional exchanges, for the sole purpose of ultimately creating a hypothetical profit of which the Fund would get some share. Indeed, if a brokerage affiliate for purposes of regional membership were formed, and it exactly broke even, the Fund would get nothing whereas the

Adviser would have saved between $150,000 to $200,000 in overhead.

**C. Director Stanley Law Sabel**

Sabel had suffered strokes and was deposed by plaintiffs (Ex. 23, p. 4, Ex. O) both in this action and the prior action (67 Civ. 70). Practising since 1932 in New York, member of Massachusetts and Connecticut bars,* a specialist in securities law, author of law review notes, holder of both LLB and LLM in corporation finance from Harvard, Sabel has continued as director of the Fund since inception.

His opposition to brokerage involvement was deliberate and principled, as well as soundly grounded on the judgment "Shoemaker stick to your last" (Ex. 23, p. 38). He clearly recognized that suggestions in the 1966 SEC report (Ex. 4) as to recapture were not applicable to a no-load fund. Copies were furnished all directors (Ex. 23, pp. 20-24). He pointed precisely to the language in Ex. 4 relating to ". . . dealer distributed funds" which shows the distinction in the SEC's own mind with respect to "recapture" availability (Ex. 23, pp. 54-55).

Sabel recognized the inherent conflicts in self-dealing brokerage for the Fund (Ex. 23, pp. 32, 36-38, 50 81-83), and the opposition of disinterested directors, particularly Radcliffe and Fowler to any such conflict or sham and deceit.

Sabel was entirely familiar with the NASD rules for eligibility, and indeed it was those rules which had occasioned correspondence with the NASD (Ex. A) in March 1967.

* Mr. Sabel has since passed and been admitted to the Georgia bar, where he resides at Saint Simons Island.



He would not advise a "deceitful" (Ex. 23, p. 43) "letter drop".

At pp. 41-49 (Ex. 23) Sabel carefully analyzed the NASD eligilibitly requirements, especially at p. 46, where he quoted ". . . whose regular course of business consists in actually transacting any portion of the brokerage or investment banking business." (Also Ex. 23, p. 88)

With respect to the Pacific Coast Stock Exchange, where plaintiffs contend there could have been some gross dollars "recaptured" before expenses. Sabel noted with precision the prerequisite of NASD membership to participate in that regional exchange, under whatever umbrella (Ex. 23, pp. 52-54). All of this had been his, as general counsel's, advice to the directors (Ex. 23, pp. 66-67). All prospectuses and proxy statements fully disclosing the Fund's brokerage practices—as the trial Court found (A. 21)—had been provided to directors before their meetings (Ex. 23, pp. 78-79).

**Defendants as Innocent Bystanders in Three-Cornered War**

An early, wild shot in the three-cornered war between the SEC, Congress and the New York Stock Exchange was a single sentence appearing on page 173 of the 346 page PPI December 5, 1966 report. Without reference to direct mail, or no-load funds, the Commission conjectured that since four huge complexes (having captive sales forces) had become members of the Pacific Coast Exchange, and shirking its duty to press for reasonable rates, and launching a suggestion for a preferential advantage arising out of self-dealing stated that:

> "It would not be inconsistent with those rules for *dealer-distributed* funds to direct give-ups to the *adviser-*

*underwriters,* all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds." [82] (emphasis added)

"[82] Alternatively, the fund itself could form a broker-affiliate to which it could direct give-ups. If this course were followed—and no fund now does so—the give-ups would inure to the direct benefit of the funds' shareholders."

That staff report totally ignored the standards of *SEC* v. *Capital Gains Research Bureau, supra,* enunciated three years before and, the very year, 1963, these plaintiffs first bought their shares.

The report carefully defined execution as "the actual work of making a trade on the exchange floor" (p. 168, n. 59).

It stated that the four mutual fund affiliates which had recently joined the Pacific Exchange "execute" orders—not only for their respective funds on that exchange floor—but also *"obtain a considerable amount of non-fund business"* from firms which are members of the New York Stock Exchange, *in return for* fund brokerage business on the New York Exchange, and that a part of the *"profits"* from that tied-business was applied to reduce the advisers fees (pp. 172, 173). (emphasis added)

This devious trial balloon was predicated upon exploiting captive customers to attract "profits" (to the *adviser*), plus swap and tie business on various floors, in a back-scratching, churn inducing charade.

Six weeks later, February 9 and 10, 1967, the General Counsel of the SEC spoke at the University of Pennsylvania, at a forum *attended by Fund general counsel, defendant Sabel.* Mr. Loomis stated (115 U.P.L. Rev. 835):

"Mr. Loomis: Herb Anderson's remarks seemed to indicate at least part of the confusion that has surrounded



this problem. He appears to feel that our objection to customer directed give-ups is a *criticism of the funds and of the fund managers, and that the fund managers,* or the NASD, or the I.C.I., *should do something about it. We don't look at it that way—at least, I don't.* So long as the *stock exchange rules permit this way* of doing things, I don't particularly blame the funds for doing it, and the NASD and the I.C.I. have *no power* to change the rules of the stock exchanges anyhow.

"So long as the stock exchange *rules permit this practice,* it is to be expected that the funds will do something with these commissions, rather than not do anything with them. Thus, we view this as a *problem of exchange rules, not as a practice in which the funds or their managers or the NASD or the I.C.I. are in any way delinquent.* Of course, this system does create, as the report points out, and as Bob and I have mentioned, an incentive for funds, and perhaps for fund salesmen, to do things which raise questions. But by and large this is *not a problem of any misconduct on the part of funds or fund managements,* but, in our view, a defect in the exchange commission rate structure." (Emphasis added)

The opportunities for palming off overhead, allocations of expenses and consolidated tax, temptations to churn, and the fact that only *"net* profits" from brokerage would be considered were belatedly stated by the SEC in its *Institutional Investor* Study which in 1971 recognized.

> "Even if a fund adviser offsets the management fee by the total *net* income earned by an affiliated broker on the funds' transaction, it may still receive financial benefits from the arrangements. For instance, one such arrangement provides for the deduction of an allowance for income taxes of the brokerage affiliate in determining the brokerage affiliate's net income. Since the

adviser and the brokerage affiliate filed a consolidated tax return the *after-tax income of the adviser is increased.*" (House Document No. 92-64, 92d Cong., 1st Sess., part 4, pp. 2298-99 (1971).) (emphasis added)

In a footnote the *Study* explains the process in more detail:

> "For example, a mutual fund manager with a scheduled fee of $2 million and a brokerage subsidiary with pre-tax income of $1 million would offset the management fee by $500,000 (assuming a 50 percent tax rate). On consolidated pre-tax income of $2.5 million ($1.5 million management fee and $1 million in brokerage net income) the adviser would net $1.25 million after taxes. Without the subsidiary the adviser would have received a $2 million fee on which it would have netted only $1 million after taxes." (*Id.* at 2299 n. 91.)

But even earlier, upon the proclamation of proposed Rule 10b-10 in January 1968, never adopted and withdrawn, suggesting "recapture" by "*dealer*-distributed" funds, Commissioner Smith in dissent stated the proposal:

> ". . . would only exacerbate the sometime byzantine arrangements among brokers with respect to give-ups without meeting directly the basic problem, which is a reasonable level of commission rates."

Yet, on January 29, 1972, the SEC answered the request of the Sears Roebuck empire, whose mutual fund affiliate had obtained PBW membership, that it be permitted to reduce management fees paid by the fund by the *entire* amount of the PBW members *net* income attributable to both direct and tied-in fund brokerage business. The Staff refused to issue a no-action letter stating:



> "As you know, the Commission is considering the problem of institutional access to National Security Exchanges. The resolution of this problem may affect the proposed arrangement among Fund, Manager and ATC. Because of this factor, in addition to the problems under Sections 17(e) and 17(d) of the Act and Rule 17d-1 thereunder, the *Manager, ATC, and the Fund will be acting at their own risk if they proceed with the* proposed arrangement." *Allstate Enterprises Stock Fund, Inc.* (emphasis added).

The Commission has likewise blown hot and cold on the question of obtaining preferences for tender offer "solicitation fees". Following passage of the "Williams Act",* expressly designed to prevent preferences and payments on the side, the Commission issued its Rule 10b-13 (17 C.F.R. §240.10b-13 1975). Thereafter the Commission in its Release No. 9920 (December 27, 1972, CCH Fed. Sec. L. Rep. ¶79156) stated that it viewed "the payment by a tender offerer of a soliciting dealer's fee, directly or indirectly, in part or in whole, to a tendering shareholder, as compensation otherwise than pursuant to such tender or exchange offer." And it went on to state, with particular reference to mutual funds, that the proposed amendment was intended to assure that no soliciting fee be paid back directly or indirectly to any "tendering shareholder or its affiliate" which was described as "any investment adviser to any investment company".

The Commission's Release No. 10,102, CCH Fed. Sec. L. Rep. ¶ 79,327, issued in 1973 was a complete flipflop, indicating that a Fund manager may have "an obligation to name an *affiliated* broker" to receive solicitation fees, thereby accomplishing the very preference and discrimination which the Williams Act was designed to outlaw.

* 82 Stat. 455 (1968), 15 U.S.C. § 78n(d)(7).

## Reasons for Granting the Writ

The decision below cannot be reconciled with *Ernst & Ernst* v. *Hochfelder*, —— U.S. ——; *Gordon* v. *New York Stock Exchange*, 422 U.S. 659; *United States* v. *NASD*, 422 U.S. 694; *Cort* v. *Ash*, 422 U.S. 66, and *SEC* v. *Capital Gains Research Bureau, supra.*

It is of utmost public importance that any "implied" remedy under the 1940 Act be fully considered in the light of the express remedy in §36(b) added in 1970, which in subdivision §36(b)(1) shifted to the *plaintiff* the burden of proof of violation of fiduciary obligation, and in §36(b)(3) limited recovery to the amount of "compensation or payments *received* from such investment company, or the security holders thereof, *by such recipient.*"

Indeed, counsel for plaintiffs has himself attested to the public importance, being quoted the day after the decision (Wall Street Journal, December 31, 1975, p. 5)

> "Mr. Pomerantz predicted a 'chain reaction' of suits in New York against other advisers of mutual funds that haven't tried to recapture commissions."

Further, this case conflicts directly with the First Circuit's decision in *Moses* v. *Burgin*, 445 F.2d, 369, 375, involving a "load" fund having a functioning underwriter, holding:

> '. . . *the directors had no duty* to pursue plaintiff's suggested course of action, and without their doing so, recapture was not freely available. Plaintiff knew of Fund's practice when she bought her shares; *she could have chosen a fund that did have an affiliated broker.*" (Emphasis added)



While it is admitted that defendants were ineligible to join the major cartel, the NYSE, had they in fact created a bona fide brokerage business, under §17(e) of the Act defendants could have kept in their own pocket the gross amount of "the usual and customary broker's commission" for transactions on *regional* cartels, 2% on secondary distributions and 1% on over-the-counter transactions.

Supervening statutory amendments in 1970 and 1975 now require *all* investment companies and their advisers to conform to the actual practice of defendants in the past, including, specifically, the requirements under the Adviser's Act that all mutual fund advisers now register as advisers (§203(b))* and section 6 of the Securities Act Amendments of 1975 which finally divorces investment management from the brokerage with which defendants had no link, legal or meretricious.

In *Capital Gains Research* this Court was especially concerned with impairment of investment judgment (375 U.S. at 190) stating:

> ". . . not engaged in any activity such as security selling or brokerage, which might directly or indirectly bias an investment judgment. . . ".

And the Court stated earlier

> "The report stressed that affiliations by investment advisers with investment bankers, or corporations might be 'an impediment to a disinterested, objective, or critical attitude toward an investment by clients. . .'" (at 187-188),

and further:

> "The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment

* 15 U.S.C. 80b-3(b)(2) and (3), as amended 1970, P.L. 91-547.

counsel associations, which contained the following canon:

> "[An investment adviser] should continuously occupy an impartial and disinterested position, as free as humanly possible from the *subtle* influence of prejudice, *conscious or unconscious;* he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect." (at 188, emphasis the Court's)

The conflict with the *Gordon* and the *NASD* cases is equally apparent. The SEC at all times had the power under the Securities Exchange Act of 1934 and under the Advisors Act and under the Investment Company Act of 1940 to make all needful rules and regulations applicable to the exchanges themselves, or to investment companies alone, to have raised its ephemeral views and transient notions (or "remarks") into rule or regulation.

In the *NASD* case this Court quoted in Note 45 the Commission Chairman's report to Congress including:

> "No issuer of securities is subject to more detailed regulations than a mutual fund."

In the next to the last paragraph of "IV A" this Court stated:

> "The SEC's election not to initiate restrictive rules or regulations is precisely the kind of administrative oversight of private practices that Congress contemplated when it enacted §22(f)."

In *Gordon,* the SEC's active concern for competition did not *mandate* competition until formal *action* by the SEC.

The SEC's thinking out loud for more than 10 years did not change its regulations having the force of law.



That portion of its thinking out loud directed to investment companies did not change the regulations or rules relating to mutual funds, any more than it did the regulations under §19 of the Securities Exchange Act of 1934.

Leviathan acts by thrashing its tail—not by vapor spouts. "Thar' she blows" is not an adequate *ratio decidendi* for determining official action.

Collateral attack, both public and private, ". . . where [the SEC] has not deemed it appropriate to prohibit the conduct," has been precluded. *U.S.* v. *NASD,* note 41 and accompanying text including Court's statement "We agree."

In the *NASD* case we invite special attention to notes 3, 13, 21, 22 and 45, together with the accompanying text.

Here there is no showing of violation or failure to adhere to any rule or regulation of the SEC, or of any exchange, or of the NASD.

The administrative oversight by electing "not to initiate restrictive rules or regulations" would further appear to require full consideration of the provisions of Section 38(c) of the Act which provides "no provision of this title imposing any liability shall apply to any act *done or omitted* in good faith conformity with any rule, regulation, or order of the Commission. . ." (Emphasis added).

The public importance of this case is further emphasized by its unique characterization of brokerage:*

> "The adviser in the present case originates transactions for many investors in addition to the Fund; *if that were not enough,* something might be said for piercing the corporate vail and regarding the adviser as acting 'for the account of' for the Fund's shareholders" (A71) (emphasis added).

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* Without regard to capacity.

and the suggestion on the following page

> "the term 'broker' . . . could well include an adviser placing buy and sell orders for the portfolio of a mutual fund. . ." (A72)

This Court's opinion in *U.S.* v. *NASD,* in Note 3* stated the law to the contrary with respect to the Exchange Act of 1934 and in Notes 21** and 22*** gave the definitions from the 1940 Act of dealers and brokers in the margin.

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* "3. In this opinion we will use the term "broker-dealer" to refer generally to persons registered under the Securities Exchange Act of 1934, 15 USC §§ 78o et seq. [15 USCS §§ 78o et seq.], and authorized to effect transactions or induce the purchase or sale of securities pursuant to the authorization of that Act. We also will refer separately to "brokers" and "dealers" as defined by the Investment Company Act, see 15 USC §§ 80a-2(a)(6) and (11) [15 USCS §§ 80a-2(a)(6) and (11)], to describe the capacity in which a broker-dealer acts in a particular transaction.

** "21. The Investment Company Act defines a "dealer" to be:

> "[A]ny person regularly engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, insurance company, or investment company, or any person insofar as he is engaged in investing, reinvesting, or trading in securities, or in owning or holding securities, for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business." 15 USC § 80a-2(a)(11) [15 USC § 80a-2(a)(11)].

A "broker," by contrast, is defined to be:

> "[A]ny person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank or any person solely by reason of the fact that such person is an underwriter for one or more investment companies." *Id.,* § 80a-2(a)(6).

*** "22. Congress employed the term "broker" without reference to "dealer" in various sections of the Act. See id., §§ 80a-8(c)(2); 80a-10(b)(1); 80a-17(e)(1) and (2). In other instances, the Act refers to "dealer" without reference to "broker," see id., §§ 80a-2(a)(40); 80a-22(c) and (d). And in some cases, including the very definition of the term "dealer" itself, see n. 21, supra, the



The exhaustive discussion of implied liability in *Ernst & Ernst* v. *Hochfelder* need not be repeated, but we may refer to

> "The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support."

In the present case there is no victim.* There is no loss. There is no unjust enrichment. There is nothing to be restored. No defendant ever received a red cent with which to pay a judgment of liability. There is neither violation of law, nor failure to abide by regulation or any rule of an exchange. There is no negligence.

There was full disclosure.

The SEC could not have obtained a mandatory injunction to compel vertical integration into the brokerage business which was not required by statute.

As a matter of statute law there is not one word to support either the complaint or the decision below.

As a matter of fact and as a matter of law, no one could have "relied" on anything other than the full disclosure in the prospectuses and proxy statements.

The remedial provisions of the Act are ripe and important for determination.

On February 9, 1976 a different panel of this Circuit heard argument in *Tannenbaum* v. *Zeller* (75-7503) wherein

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Act refers to both "broker" and "dealer" in the same provision, see id., §§ 80a-1(b)(2); 80a-9(a)(1) and (2); and 80a-30(a). Finally, the Act in some cases refers to the more general term "broker-dealer," see id., §§ 80a-22(b)(1) and (2).

* The recurrent term "excess commissions" is the SEC's noncompetitive own proper progeny.

the SEC has filed the first week in May a 50 page brief in support of *affirmance* of a decision of no liability where a fund did no business with its affiliated NYSE member firm.

It would be anomalous indeed if liability were fastened for failure to enter a new business, while abjuring an existing vehicle would exculpate.

## CONCLUSION

This Court does not sit to right wrongs nor to trim excrescences; but, nevertheless, obedience to unskewed shape of statutes must remain its constant concern.

It is respectfully submitted that this Court should grant the Petition and issue the Writ prayed.

Respectfully submitted,

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# APPENDIX

**Denial of Petition for Rehearing**

UNITED STATES COURT OF APPEALS

For the Second Circuit

Docket No. 74-2582

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the seventeenth day of February, one thousand nine hundred and seventy-six.

Present:

Hon. Henry J. Friendly,
Hon. Paul R. Hays,
Hon. Wilfred Feinberg,

*Circuit Judges.*

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Rosalind Fogel and Gerald Fogel,

*Plaintiffs-Appellants,*

v.

George A. Chestnutt, Jr., John Currier, Frank G. Fowler, Jr., Warren K. Greene, Richard W. Radcliffe, Stanley L. Sabel, Francis L. Veeder, American Investors Corp., American Investors Fund, Inc., and Chestnutt Corp.,

*Defendants-Appellees.*

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*Denial of Petition for Rehearing*

A petition for a rehearing having been filed herein by counsel for the defendants-appellees (other than American Investors)

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

A. Daniel Fusaro
*Clerk*



**Judgment**

UNITED STATES COURT OF APPEALS

For the Second Circuit

Docket No. 74-2582

At a stated Term of the United States Court of Appeal for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirtieth day of December, one thousand nine hundred and seventy-five.

Present:

Hon. Henry J. Friendly,
Hon. Paul R. Hays,
Hon. Wilfred Feinberg,

*Circuit Judges.*

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Rosalind Fogel and Gerald Fogel,

*Plaintiffs-Appellants,*

v.

George A. Chestnutt, Jr., John Currier, Frank G. Fowler, Jr., Warren K. Greene, Richard W. Radcliffe, Stanley L. Sabel, Francis L. Veeder, American Investors Corp., American Investors Fund, Inc., and Chestnutt Corp.,

*Defendants-Appellees.*

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Appeal from the United States District Court for the Southern District of New York.

*Judgment*

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is reversed and the action be and it hereby is remanded to the District Court for further proceedings in accordance with the opinion of this court with costs to be taxed against the appellees.

A. Daniel Fusaro
*Clerk*

By Vincent A. Carlin
*Chief Deputy Clerk*



**Decision of District Court (383 F.Supp. 914)**

WYATT, District Judge.

This is the decision after trial without a jury on the issue of liability alone. There will be judgment for defendants on this issue.

Plaintiffs are and have been since January 11, 1963 holders of record of shares of capital stock of American Investors Fund, Inc. (Fund), a New York corporation. Fund is a diversified open-end management investment company registered as such under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 and following ("the 1940 Act"); see §§ 80a-3, 80a-4, 80a-5, 80a-8). Fund is one of the many companies usually called a "mutual fund". Fund does not charge a "sales load" (commission) on its shares sold (15 U.S.C. §§ 80a-2(a)(35), 80a-10(d).

Fund was organized in 1957 and had for some time as its investment adviser, American Investors Corporation. Since July 19, 1966, the investment adviser of Fund has been Chestnutt Corporation (Adviser), a Connecticut corporation which acquired all the assets of Ameri-

can Investors Corporation. For simplicity the term "Adviser" will usually be meant to include American Investors Corporation. The Adviser manages Fund and acts under an investment advisory contract between it and Fund.

George A Chestnutt, Jr. (George), for whom the Adviser is named, is president and principal stockholder (47%) of the Adviser and president and a director of Fund. He has been the chief figure in Fund and in the Adviser.

The action was commenced on July 11, 1968, and is a derivative one on behalf of Fund (a nominal defendant). The action is also said to be brought "representatively" for all other "shareholders of the Fund similarly situated"; what this means is not clear.

The named defendants are the Advisor, its predecessor (American Investors Corporation) and the seven directors of Fund when the action was commenced. Four of these individual defendants were served and defended: George, Currier, Greene, and Sabel. Currier is a director of Fund and owns



voting common stock (2%) of the Adviser; he is a corporate executive in the women's wear field. Greene is vice president and a director of Fund and vice president and a small stockholder (0.4%) of the Adviser. Sabel is a lawyer and a director of Fund; before his retirement in 1971, Sabel was senior vice president and secretary of Fund and was also vice president, secretary, director, and substantial stockholder (16%) of the Adviser (he may still be a substantial stockholder of the Adviser).

The complaint named three other directors of Fund who were not served and did not appear: Fowler, Radcliffe, and Veeder.

Jury trial was demanded by plaintiffs.

The complaint in one count avers a claim that the Adviser and the individual defendants enriched themselves at the expense of Fund by the use of "reciprocal brokerage" and "give-ups". Specifically, the charge is that defendants violated the 1940 Act "by failing

to recapture brokerage commissions for the Fund" (Post-Trial memo for plaintiffs, p. 2).

The complaint avers that this Court has jurisdiction under the 1940 Act and also under the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 and following) and the Securities Exchange Act of 1934 (15 U.S.C. § 78a and following; "the 1934 Act"). Plaintiffs appear to rely solely on the 1940 Act.

By order filed June 29, 1973, it was directed that "the issue of liability will be tried separately and before the issue of damages". The Court was advised at that time that the action would be tried without a jury.

A pretrial order signed September 4, 1973 (but for some reason not filed until October 4, 1973) noted that the right to a jury trial had been waived by "both parties".

Without opposition by defendants, the plaintiffs were permitted to serve and file a supplemental complaint, the principal (if not only) function of which was to bring the complaint down to date.



The supplemental complaint was filed on August 24, 1973 (a copy with verification added was filed on August 30, 1973). No order was made that defendants plead to the supplemental complaint (Fed.R. Civ.P. 15(d)); note was taken of this situation at trial and new paragraphs of the supplemental complaint were "deemed denied" (SM 6; SM references are to pages of the stenographic minutes).

It is difficult to tell the time period for which this action is brought. Based on the averments in paragraphs 21(a) and 23(a) of the supplemental complaint, it would appear to be from January 1, 1965 down to date. For reasons which will appear, however, the claim as to give-ups must end on December 5, 1968, and the claim as to reciprocal brokerage must end on July 15, 1973. Counsel for plaintiffs insist (SM 65) that membership on two regional exchanges would have yielded preferences thereafter, but, as will appear, SEC Rule 19b-2 prohibited this, effective March 15, 1973.

1.

Since 1964, Fund has had either eight or seven directors.

With respect to directors, the parties have used the terms "affiliated" and "unaffiliated" but have not defined these terms. The 1940 Act uses the expression "interested persons" in referring to directors (15 U.S.C. § 80a–10(a)) which is elsewhere defined to include an "affiliated person" (15 U.S.C. § 80a–2(a)(19)(A)(i)) which latter term is elsewhere defined (15 U.S.C. § 80a–2(a)(3)). For purposes of this action, an affiliated director may be considered as one connected with or having an interest in Advisor, as opposed to an independent director, having no connection with or interest in Adviser.

Since 1964, Fund has had either three independent directors out of seven or four independent directors out of eight. Fund has had four affiliated directors. Currier is counted as an affiliated director because, while not employed by Advisor, he has owned 2% of the voting common stock of Adviser.



Fund and Adviser had the same counsel. Sabel and his firm were counsel to both until 1971 or 1972. Clendon H. Lee, whose wife has been for a long time the owner of a small amount (1%) of the voting common stock of Adviser, became special counsel to Fund in 1965 and his law firm has acted as counsel to Fund since at least April 28, 1972.

Under the investment advisory contract, Adviser manages and advises Fund, furnishes all offices to Fund, pays all officers and employees of Fund, and in short does everything for Fund.

Fund pays nothing for expenses except fees to directors.

Under the investment advisory contract, Fund pays the Adviser for its services on an annual rate of a percentage of the net asset value of Fund. These payments have been substantial, ranging from $187,000 in 1964 to $1,557,000 in 1969.

2.

The charges in this action had their origin in the size of the transactions made on stock exchanges by mutual funds and other institutions. As these transactions developed, they involved buying and selling large blocks of shares and at the rates fixed by the exchanges (no quantity discounts) the brokerage commissions became so great that members of the exchanges could execute fund transactions at a cost of only a small part of the commissions which had to be charged. Naturally, exchange members were eager for mutual fund business and would have been willing to rebate part of their commissions to the customer mutual funds but were prevented by exchange rules from doing so.

In this climate, brokers had a strong motive to give help to managers of mutual funds by (a) selling shares of the fund or (b) supplying the manager with investment research and advice, or (c) doing both. The manager of the mutual fund would then allocate part of its brokerage business to such helpful brokers,



and could see that the commissions earned by such helpful brokers bore a relation to the value of the sales efforts and of the research and advice. Those allocated orders were known as "reciprocals".

For some funds, especially big funds, it became undesirable to allocate brokerage orders on the basis of the value of non-brokerage services rendered. This was principally because sales of the mutual fund shares were made by many independent brokers or dealers; to send brokerage transactions through so many brokers would not be prudent from a management standpoint, this for many good reasons.

To meet this situation, the brokers and mutual fund managers worked out the technique of the "give-up".

The give-up technique was that the broker who executed the fund transaction surrendered a part of his commission to other brokers designated by the customer fund, acting of necessity through the fund manager. In this way,

the fund manager could spread the commissions on fund executions among a number of brokers, who, although they had nothing to do with execution of the transaction, had been otherwise helpful in selling fund shares or in giving investment advice or both.

Brokers executing transactions for mutual funds were willing to give up as much as 75% or more of their commissions.

As might be expected, the Securities and Exchange Commission (SEC) became concerned with the influence of fund and other institutional transactions on the structure of the market for securities, as well as with the fixed rates (without quantity discounts) charged under exchange rules. It was this last feature which had resulted in the development of reciprocals and give-ups.

The give-up technique was not without its limits. Because of a rule of the New York Stock Exchange (NYSE), commissions on transactions there could only be given up to other members of that exchange. The regional exchanges, as a way of competing with NYSE, were less strict. Nearly all the regional exchanges permitted commissions to be given up to non-members provided they were members of National Association of Securities Dealers, Inc. (NASD).



NASD is the only "national securities association" registered with the SEC under Section 15A of the 1934 Act (15 U.S.C. § 78*o*–3; the Maloney Act (added in 1938)), the purpose of which was to establish supervised self-regulation of over-the-counter brokers and dealers. NASD has rule-making power.

The availability of give-ups posed a dilemma for fund managers. The business was that of the funds; the fund was the customer. But exchange rules prevented any rebate on the fixed commissions to the customer. Rather than leave all the commissions with the executing brokers, the fund manager directed give-ups to those brokers who sold fund shares. True, as plaintiffs argue,

this benefited the fund manager because it rewarded brokers who sold fund shares, who thus increased the assets of the fund, and who thus enabled advisory fees to increase. But it did no harm to the fund because (by definition) the fund could in no event secure a rebate. In point of fact, there was some benefit to the fund stockholders from the increase in fund assets by sale of more shares; advisory fees usually, if not always, go down on a sliding scale of ascending asset value (such was the case with Fund here).

Some fund managers, however, sought to secure a benefit to their funds by recapturing for them a part of the excess commissions available as give-ups. This was done beginning in 1965 by use of a broker-dealer affiliate who was a member of NASD, as, for example, the underwriter who sold shares of a "load" fund on a commission basis and whose qualification to be a member of NASD was clear. In at least a few instances, the fund managers created a broker-dealer subsidiary which became a member of a regional exchange. By these



means, some of the commissions on portfolio transactions were used to reduce the advisory fees of the fund managers.

The concern of the SEC with fixed commission rates (without quantity discounts on large transactions) included a concern with the give-up technique. These concerns in 1968 led to discussions between the SEC and NYSE; as a result of pressure from the SEC, give-ups on NYSE were prohibited by its rules after December 5, 1968. In response to the same pressure, all the regional exchanges prohibited give-ups at the same time.

Reciprocals could not be used after July 15, 1973, because a Rule of NASD effective that date prohibited them. (The Rule was adopted by NASD after the SEC had publicly stated that "reciprocal practices must be terminated" for a number of reasons given in the statement; see SEC Policy Statement, February 4, 1972.)

In its continuing study of the securities business, the SEC took note of the use by some fund managers of membership in regional exchanges as a means

of securing give-ups or otherwise to recapture commissions. The SEC found this to be against the public interest and on this account and for other reasons, effective March 15, 1973, the SEC adopted Rule 19b–2 under the 1934 Act. This Rule required that each member of a national securities exchange must have "as the principal purpose of its membership the conduct of a *public* securities business" (emphasis supplied), which was defined to mean that 80% in value of its exchange transactions had to be for persons not affiliated. The effect of this Rule was to make it impossible for investment companies to recapture any part of their commissions through the use of broker affiliates (unless such affiliate did 80% of its business with persons independent of the investment company, that is, was truly a "public" broker).

The SEC took note at the time (Release No. 9950, January 16, 1973, section VII(A)):

> "On the regional exchanges many subsidiaries of investment managers and insurance companies have purchased seats to trade for the account



> of the affiliated 'parent' or to be used for 'recapture' of commission dollars for that parent."

One of the principal reasons given for the adoption of Rule 19b–2 was a finding by the SEC that "membership [in an exchange] utilized primarily . . . for the purpose of . . . recapturing commissions charged on exchange securities transactions, directly or indirectly, is inimical to the protection of investors, fair dealing in securities traded in upon such exchanges, the fair administration of such exchanges and the interests of the public investors we are mandated to protect in the development of a central market system for listed securities." SEC Release No. 9950, January 16, 1973, Introduction.

It may be mentioned that Rule 19b–2 has been attacked by a regional exchange; its appeal to a court was dismissed for lack of jurisdiction, without reaching the merits. PBW Stock Exchange, Inc. v. SEC, 485 F.2d 718 (3d Cir. 1973), cert. denied 416 U.S. 969, 94 S.Ct. 1992, 40 L.Ed.2d 558 (1974).

3.

The Adviser and those interested in it—chiefly George—managed and controlled the Fund. If there were a conflict in interest between the Fund and the Adviser, the economic interest of the chief personalities would be with Adviser. In a general sense, however, what was good for the Fund was good for the Adviser, that is, the more successful and the larger the Fund became, the greater would be the advisory fee to Adviser.

In the matter of reciprocals and give-ups, there is no question but that the Adviser, acting for Fund, directed reciprocals and give-ups to brokers who sold Fund shares or who gave research material to the Adviser or both. To what extent this was done is difficult to say. According to the records, all brokerage commissions were so treated. For example, in the prospectus of Fund dated May 1, 1968 (Ex. 11) it was stated that all brokerage commissions were paid either to "brokers who provided helpful information" or to brokers "in connection with the sale of Fund shares".



In his testimony, George suggested that records for the SEC required such allocation to be made. In any event, it is clear that the Adviser directed substantial amounts of reciprocals and give-ups. The Adviser used give-ups to reward brokers who sold Fund shares, seeing to it that they got in earned commissions or give-ups at least 2% and usually more of the amount of Fund shares sold by them. Discovery into the specific amounts of give-ups was not permitted (because related to liability) but it is known that there were $326,120 in give-ups in 1967 and $633,095 in 1968. Nearly all the transactions for Fund were on NYSE but a "small percentage" was on regional exchanges (SM 286). It is known that there were $205,000 in give-ups on regional exchanges between October 1966 and November 1968.

The use of reciprocals and give-ups was fully disclosed in the prospectuses of Fund.

Mutual funds may sell their shares in a number of different ways. Some use an underwriter who buys at wholesale from the fund and sells at retail

either through an internal sales force or through independent broker-dealers who are paid a commission. Others, the no-load funds—such as Fund here—sell direct to investors or through independent broker-dealers who are not paid a commission. The use of give-ups supplied a motive to brokers for selling Fund shares; since no commission was paid on such sales, give-ups (or reciprocals) were the only reward to the brokers.

The use of give-ups and reciprocals did benefit the Adviser. Their use also benefited the Fund and its stockholders because the larger the Fund, the smaller the expenses of Fund would be per dollar of invested assets.

[1] The use of reciprocals and give-ups did not cause any damage to Fund unless plaintiffs can establish that they, or a part of them, could have been recovered for the benefit of Fund.



4.

[2] Under the theory of the case for plaintiffs, it is necessary for them to show that Fund or Adviser could have formed a subsidiary which could have properly become a member of NASD. While this is a hypothetical matter, it can be determined because the qualifications for NASD membership are in evidence (Ex. 21).

Counsel for plaintiffs insist that a subsidiary of Fund or Adviser could be a "broker" and be eligible for NASD membership; that obtaining membership would be "routine". Counsel for plaintiffs do not argue that such a subsidiary should do business with the public in competition with other brokers nor that the subsidiary should execute any transactions for Fund. The argument is that the subsidiary could secure NASD membership solely to qualify for give-ups and other preferences on regional exchanges. See Post-Trial Memorandum for plaintiffs pp. 19–41

Counsel for defendants ignore this issue and offer no help to the Court. It remains a responsibility of the Court

to reach a just determination of the issue.

It is concluded that such a specially created subsidiary of Fund or Adviser would not be eligible for membership in NASD.

The qualifications for NASD membership are in relevant part as follows (Ex. 21, p. 1049):

> "Any broker or dealer authorized to transact and whose regular course of business consists in actually transacting any branch of the investment banking or securities business in the United States, under the laws of any State and/or the laws of the United States, shall be eligible to membership in the Corporation . . .".

The definition of a "broker" is as follows (Ex. 21, p. 1059):

> "The term 'broker' means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank."



This definition is in substance that contained in the 1934 Act (15 U.S.C. § 78c (a)(4)).

A subsidiary such as plaintiffs suggest would not be "transacting any branch of the . . . securities business". It would not be "transacting" any "business"; it would simply be a device for securing a preference in commission rates for one investor over other investors. Nor would it be a "broker" since it would not be "effecting transactions in securities for the account of others". It would not be "effecting transactions in securities"; it would simply be receiving preferences. Nor would it be acting for the account of "others" (plural); the suggestion is that it act for Fund alone to qualify for preferences.

Neither the 1934 Act nor the NASD qualifications contemplate that such a device could be considered a "broker".

Counsel for the plaintiffs understandably rely on the testimony by deposition of general counsel to NASD (Ex. 20). This testimony is puzzling; it is not clear. At one point, the witness states

that there is a "free entry policy" because "Anyone can become a broker-dealer under the 1934 Act who meets the statutory requirements". This Court agrees. If the witness means that such a subsidiary as plaintiffs suggest would be eligible for NASD, I disagree. True, had there been an application, NASD might have accepted the application. This would not have established eligibility but would have been an administrative failure of NASD. In any event, civil liability cannot be imposed for failure of defendants to do what it would have been deceptive and improper for them to do.

5.

[3] The principle is accepted that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions. It is not shown that defendants could have properly secured any return for Fund.

Counsel for plaintiffs ably argue that there were three ways of doing this: (a) give-ups through the PBW Stock



Exchange, (b) give-ups and discounts through the Pacific Coast Stock Exchange, and (c) tender offer fees. See Post-Trial Memorandum, pp. 24–30 All three depended, however, on membership in NASD and, as explained above, the suggested subsidiary would not be eligible for NASD membership.

In addition, counsel for plaintiffs argue (Post-Trial Memorandum, pp. 30–39) that there were advantages to membership by a new subsidiary in the PBW Stock Exchange. It is accepted that membership in PBW did not require membership in NASD (SM 57–58).

These advantages, if any, were obtainable only for the period prior to March 15, 1973, when Rule 19b-2 became effective. But to secure such advantages (assuming that there were some) would require defendants to pretend that the new subsidiary was a broker, when in fact it was not, for the purpose of securing a preference over other investors by recapturing a part of the fixed commissions. While it may have been theoretically possible for PBW and the defend-

ants, in collusion and for the selfish purposes of each, to accomplish such a result, it would have been contrary to public policy. The SEC found, as already noted, that to use membership in an exchange "for the purpose of . . . recapturing commissions . . . is inimical to . . . fair dealing in securities traded in upon such exchanges . . .".

Civil liability can scarcely be imposed for failing to do what it would have been contrary to public policy for the defendants to do.

6.

Counsel for plaintiffs, with some reason, rely on Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971), cert. denied 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971), and argue (Post-Trial Memorandum, p. 2) that "the issues and facts" in the case at bar are "virtually identical to the issues and facts" in *Moses*. The argument cannot be accepted.



Whether *Moses* was rightly decided is subject to some doubt and such doubt is permissible since the decision is not binding in this Circuit. It should be noted that *Moses* was decided in June, 1971, some time before the finding by the SEC that use of exchange memberships to recapture commissions was against public policy and before the adoption of Rule 19b-2. The *Moses* decision has not been applied in any action in this Circuit but has been discussed by Judge Gurfein in Weiss v. Chalker, 55 F.R.D. 168 (S.D.N.Y.1972) and 59 F.R.D. 533 (S.D.N.Y.1973). There is nothing in Judge Gurfein's discussion which would suggest liability in the case at bar.

For present purposes, it is assumed that *Moses* reached the right result. It is not applicable here, however, because, while the situation in *Moses* is superficially similar to that in the case at bar, the two situations on study are seen to be clearly distinguishable.

The fund in *Moses* was not (as here) a no—load fund. On the contrary it sold its shares to an underwriter (Crosby)

which was a subsidiary of the adviser and which resold the shares through independent brokers and dealers who in turn resold to investor customers who paid a commission on the purchase. Crosby was a member of NASD.

Crosby was not only a member of NASD before the *Moses* litigation began but Crosby appears properly to have qualified for such membership. Crosby's qualification for NASD membership was accepted without question by all parties in *Moses* and by the Court of Appeals (see 445 F.2d at 375). While Crosby was not a "broker" and did not deal with the general public, it was a "dealer" because it bought the fund shares for its own account and resold them "to independent broker-dealers" (445 F.2d at 371). This fits the definition of "dealer" used by NASD (Ex. 21, p. 1059).

Counsel for plaintiffs in *Moses* are counsel for plaintiffs here. In *Moses* they argued that the fund could have recovered ("recaptured") part of the commissions paid on fund portfolio transactions,



(a) by creation of a broker affiliate, or

(b) by channeling give-ups to Crosby (a member of NASD) and having Crosby credit the fund on its advisory fee.

The District Court ruled (316 F.Supp. 31) that neither method of recapture was available.

The Court of Appeals ruled that there was no duty to recapture by creating a broker affiliate but that there was a duty to channel give-ups to Crosby.

The holding in *Moses* was that if recovery ("recapture") of give-ups was "freely available" to the fund there, its directors had a duty to recover them for the fund (445 F.2d at 374). The Court of Appeals found that some of the regional exchanges "permitted members of the National Association of Securities

Dealers (NASD) who were not exchange members . . . to receive customer-directed give-ups. Crosby was a member of NASD." (445 F.2d at 375)

It is not clear on what basis the Court in *Moses* held liable the adviser and the affiliated directors. At some points, it appears to be because there was a "failure to disclose" to the unaffiliated directors "the possibility of recapture" through Crosby's NASD membership (445 F.2d at 377, 383-84). But whatever the basis of liability may be, it must rest on a conclusion by the Court of Appeals that recapture was "freely available" in *Moses*. The conclusion is never expressly stated but it is implicit in the reasoning (see, for example, 445 F.2d at 384-85).

For the reasons already given, recapture was not "freely available" in the case at bar. Thus, the decision in Moses v. Burgin has no application.

The clerk is directed to enter judgment in favor of defendants, dismissing the action on the merits.

So Ordered.



## Opinion of United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 39—September Term, 1975.

(Argued September 22, 1975 Decided December 30, 1975.)

Docket No. 74-2582

ROSALIND FOGEL and GERALD FOGEL,

*Plaintiffs-Appellants,*

v.

GEORGE A. CHESTNUTT, JR., JOHN CURRIFR, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION and AMERICAN INVESTORS FUND, INC.,

*Defendants-Appellees.*

Before:

FRIENDLY, HAYS and FEINBERG,

*Circuit Judges.*

Appeal by plaintiffs, stockholders in a no-load mutual fund, in a derivative action against the investment adviser and several of its directors, from a judgment of the District Court for the Southern District of New York, Inzer B. Wyatt, *Judge,* 383 F. Supp. 914 (1974), dismissing the action on the merits.

Reversed for computation of damages.

ABRAHAM L. POMERANTZ, Esq., New York, N.Y. (Richard M. Meyer, Esq., William E. Haudek, Esq., Daniel W. Krasner, Esq., and Pomerantz Levy Haudek & Block, Esqs., of Counsel), *for Plaintiffs-Appellants.*

CLENDON H. LEE, Esq., New York, N.Y. (Rogers Hoge & Hills, Esqs., of Counsel), *for Defendants-Appellees (other than American Investors Fund, Inc. Nominal Defendant).*

DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD (Edward N. Sherry, Judson A. Parsons, Jr., and Martin A. Schwartz), *for Lord, Abbett & Co., as Amicus Curiae.*

FRIENDLY, *Circuit Judge:*

More than four years after the First Circuit decided *Moses* v. *Burgin,* 445 F.2d 369 (1971), reversing 316 F. Supp. 31 (D. Mass. 1970), concerning the duty of the managers of a mutual fund to recapture brokerage commissions for the benefit of the fund, this court is confronted with the problem for the first time. In reviewing Judge Wyatt's dismissal on the merits of a recapture action in the District Court for the Southern District of New York, 383 F. Supp. 914 (1974), we must determine whether we agree with the First Circuit's decision and, if so, whether it applies to the somewhat different facts here at issue. With some qualifications our answers to both questions are in the affirmative. We therefore reverse and remand for the determination of damages.



## I. *The Root of the Problem.*

The present is one of what we understand to be a large number of derivative stockholders actions brought on behalf of mutual funds against investment advisers, distributors, and directors of both,[1] primarily in consequence of remarks in the SEC's Report on the Public Policy Implications of Investment Company Growth (PPI) 16,172-73 (1966), House Report No. 2337, 89th Cong. 2d Sess.

The basic factual situation giving rise to the recapture problem is well described in Judge Wyatt's opinion, 383 F. Supp. at 916-18, in the opinion of Judge Wyzanski, 316 F. Supp. 31 (D. Mass. 1970), and the reversing opinion of the First Circuit in *Moses* v. *Burgin, supra,* in PPI, and in countless law review notes and articles both before and after *Moses.*[2] Accordingly we shall endeavor to be brief in our statement of the problem and will assume familiarity with the typical structure of the externally managed open-end mutual fund, a mere shell whose investment and man-

1 A 1971 article stated there had been fifty. Butowsky, Fiduciary Standards of Conduct Revisited—*Moses* v. *Burgin* and *Rosenfeld* v. *Black,* 17 New York Law Forum 735, 736 (1971), see also Comment, Mutual Funds and Independent Directors: Can Moses Lead to Better Business Judgment, 1972 Duke Law Journal, 429, 430 n.8. Some such suits have been settled, *e.g., Weiss* v. *Chalker,* 55 F.R.D. 168 (S.D.N.Y. 1972), 59 F.R.D. 533 (S.D.N.Y. 1973). Another action has recently been dismissed on the merits, although on grounds differing, at least in considerable part, from those adopted by the district court in the instant case. *Tannenbaum* v. *Zeller,* CCH Federal Securities Law Reports ¶ 95,257 (Carter, D.J. 1975).

2 In addition to the articles cited in n. 1, see The Use of Brokerage Commissions to Promote Mutual Fund Sales, 68 Colum. L. Rev. 334 (1968); Conflict of Interest in the Allocation of Mutual Fund Brokerage Business, 80 Yale L.J. 372 (1970); Miller and Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U.L. Rev. 35 (1971); Fiduciary Obligations of Mutual Fund Managers in Portfolio Transactions, 22 Syracuse L. Rev. 1107 (1971); Note, 60 Georgetown L.J. 1594 (1972); Note, 13 Wm. & Mary L. Rev. 530 (1971).

agement functions are performed by an adviser and whose sales are handled either by the adviser (or the fund itself) in the case of no-load funds or by a distributor (which may or may not be identical with the adviser) in the case of load funds.

At the root of the recapture problem was the historic practice of the New York Stock Exchange (NYSE) and other exchanges of charging a fixed rate of commission on each share traded regardless of the size of the transaction (except for the odd-lot differential). Since the costs of executing an order do not vary in accordance with size, the large sales and purchases at the command of investment advisers of mutual funds were particularly attractive orders. At first fund managers allocated their brokerage business to reward brokers who had been helpful in selling the fund's shares, in furnishing advice, or in doing both;[3] orders allocated as rewards were known as "reciprocals." However, as the business grew, the practice of reciprocals resulted, especially for the large funds, in using too many brokers, some of whom were not the best qualified to execute the particular order placed with them. Hence there developed the practice of relying on a few executing brokers who were then instructed to "give-up" a portion of their commissions, sometimes as much as 75%, to another broker whom the fund manager wished to reward. On NYSE this was permitted only in favor of another member, but six of the seven regional exchanges permitted "give-ups" in favor of non-members as well, provided they were members of the National Association of Securities Dealers, Inc. (NASD).

There was an obvious tension between the give-up and those representations made by the investment company in

3 Some brokers rendered other services, such as making the required daily computation of the fund's net asset value, see PPI at 164.



its prospectuses which investors would be likely to understand as meaning that the amounts paid to the investment adviser constituted the fund's cost for management and investment advice and, in the case of "load" funds, that the amounts retained by the distributor constituted the cost of sales. In fact, the management-directed "give-ups" to non-executing brokers represented additional amounts that were being paid for advising, selling or both, and the true costs of these services were thus higher than the advisory fee or the sales load. To the extent that a management company restricted its own research because of what was being furnished by brokers who were rewarded with give-ups or that a distributor retained for itself a larger part of the sales load than would have been competitively feasible in the absence of give-ups, the stipulated management fees yielded greater profits than they otherwise would have. The practice entailed other evils unnecessary here to detail. Still, if there was no way for a fund to "recapture" the excess of the fixed and unvarying commissions over what the executing broker would willingly accept, something was to be said for using the excess to reward brokers who had served the fund in some fashion rather than simply overpaying the executing broker. The SEC put its finger on the problem as early as 1963 when it said in its Report of the Special Study of Securities Markets, House Doc. No. 95, 88th Cong. 1st Sess. p. 234:

> The Special Study concludes and recommends:
>
> 1. The pattern of reciprocal business in the mutual fund industry is unique. The economies of the volume of securities transactions generated by the mass purchasing power of the funds for the most part are of minor benefit to the funds themselves. The primary beneficiaries are their investment advisers and their frequently related principal underwriters, who to a

large extent use reciprocity to reward the sales efforts of fund retailers, thereby increasing their own rewards. The use by fund advisers of investment advice and research provided by brokerage firms in return for fund brokerage, without diminution of their investment advisory fees, is another indication of the manner in which they are the primary beneficiaries of reciprocal business. This unbalanced reciprocal structure is a direct outgrowth of a minimum commission rate structure which prohibits volume discounts and rebates. In the broad study of the commission rate structure recommended to the Commission in chapter VI-I, appropriate consideration should be given to the desirability and appropriate form of a volume discount from the viewpoint of mutual funds.

As developed by Mr. Justice Blackmun in *Gordon* v. *New York Stock Exchange, Inc.*, —— U.S. ——, —— (1975), 43 U.S.L.W. 4958, 4961-62, reform of the commission rate structure had a long gestation period. Meanwhile a few adviser-underwriters decided to recapture for their funds some of the spread between the fixed and unvarying commissions payable to executing brokers and the lesser amounts the latter were willing to accept on large orders. In a discussion of this development, at 172-73, PPI echoed the Special Study's criticisms of mutual fund reciprocal and give-up practices and continued in a passage meriting full quotation, pp. 172-73:

(a) *Use of brokerage commissions to benefit the funds*

(i) *Reducing advisory fees.*—As has been noted, subsidiaries of four adviser-underwriters that maintain their own retail sales forces—among them three of the largest, Investors Diversified Services, Inc.,



Waddell & Reed, Inc., and Channing Financial Corp., as well as the smaller Imperial Financial Services, Inc.—are now members of the Pacific Coast Stock Exchange. These subsidiaries execute orders for the funds on the Pacific Coast Stock Exchange. More important, however, they obtain a considerable amount of nonfund business from broker-dealers who are dual members of the Pacific Coast Stock Exchange and other exchanges in return for fund brokerage business on other exchanges, primarily the NYSE. All the net profits of IDS's subsidiary and about 40 to 50 percent of the net profits of Waddell & Reed's and of Imperial Financial Services' subsidiaries have been applied to reduce advisory fees payable by the funds in those complexes.

Widespread emulation by institutional investors of the precedent set by these four complexes could have a marked effect on the economics of the securities industry. Within the framework of the existing commission rate structure it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions. However, among dealer-distributed funds the important role that portfolio brokerage plays in the competition for dealer favor has kept fund managers, with few exceptions, from using exchange memberships to reduce costs of the funds.

Similar competitive factors have also operated against the use, for the benefit of the funds and their shareholders, of regional exchange rules permitting give-ups to any member of the NASD on transactions executed on those exchanges. It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of apply-

> ing these give-ups to reduce the advisory fees payable by the funds. Unless and until such procedures become widespread, any adviser-underwriter to a dealer-distributed fund who chose to utilize fund brokerage in this manner would place itself at a disadvantage in competing for the interest of nonmember dealers in selling the fund shares which it distributes. (Footnotes omitted.)

This passage followed an earlier summary in which PPI had written, beneath the heading "(c) Impact of mutual fund reciprocal and give-up practices," p. 16:

> Under existing commission rate structures, mutual fund shareholders could derive greater benefits from their brokerage commissions if the give-up portions of the commissions were transmitted to the funds themselves or their adviser-underwriters for the purpose of reducing management costs. However, in the face of competitive pressures managers of the dealer-distributed funds have not used brokerage for this purpose. (Footnote omitted.)

Postponing further developments on the SEC front for discussion in Part III of this opinion, we turn with this background to the case at hand.

## II. *The Proceedings in the District Court.*

This action was brought in July, 1968 by two stockholders of American Investors Fund, Inc. (the Fund) on behalf of the Fund. The Fund is a diversified open-end, no-load management investment company registered under the Investment Company Act. From the date of its organization in 1957 until July, 1966, its investment adviser and manager was American Investors Corporation; since that date



the adviser and manager has been Chestnutt Corporation. We shall refer to the two collectively as the Adviser. The chief figure both in the Fund and the Adviser has been George A. Chestnutt, Jr. The amended complaint alleged that as a result of the growth of the Fund, fees paid to the Adviser rose from such modest amounts as $93,347 in 1963 and $187,083 in 1964 to figures exceeding $1 million in the period 1967-70, the highest being $1,557,000 in 1969.

The supplemental complaint continued with allegations concerning the Fund's brokerage fees and the "allocations" of these, as shown in the following table:[4]

| | *Brokerage fees* | *Allocated to brokers who had provided helpful information* | *Allocated to brokers who had assisted in the sale of Fund Shares* |
|---|---|---|---|
| 1964 | $ 275,000 | $ 162,000 | $ 113,000 |
| 1965 | 387,000 | 247,000 | 140,000 |
| 1966 | 551,668 | 261,913 | 289,755 |
| 1967 | 1,995,087 | 935,966 | 1,059,121 |
| 1968 | 3,122,160 | 2,022,457 | 1,099,703 |
| 1969 | 2,489,281 | 1,196,059 | 1,293,222 |
| 1970 | 2,059,234 | 1,108,667 | 950,000 |

The supplemental complaint[5] continued that, by awarding reciprocal brokerage, sales of Fund shares are stimulated (with attendant increases in the advisory fee), and brok-

4 Since the sum of the second and third columns approximately equals the first, they substantially overstate the amount of commissions that would have been recaptured on any view.

5 A separate action, *Fogel* v. *Chestnutt*, 67 Civ. 60 (S.D.N.Y.), was brought in January, 1967, charging that I.O.S. Ltd., there a defendant, had caused a corporation which it dominated to cause the Fund to use a particular broker when that broker's research and advisory services were channeled to I.O.S. and not to the Fund. See *Fogel* v. *Chestnutt*, 296 F. Supp. 530 (1969). This case was "statistically closed" on April 25, 1975.

ers are used to furnish advisory services the Adviser is obligated to provide. Thus the Adviser has in effect received compensation exceeding the amounts provided in the investment advisory contract. Although an affiliate of the Fund or the Adviser could have been empowered to act as the Fund's broker and save a portion of the brokerage commission, this was not done because the Adviser "prefers to profit from such brokerage transactions used to pay its obligations by awarding the Fund's brokerage commissions to others." In what is probably its crucial paragraph the supplemental complaint alleged:

> The Fund or the Investment Adviser could have organized an affiliate for the purpose of reducing the net brokerage commissions paid by the Fund. This affiliate could have recaptured the Fund's brokerage commissions on various regional exchanges since at least January, 1965. Defendants Chestnutt, Sabel, and Greene intentionally misled and misinformed the Fund's unaffiliated directors by telling them that such recapture was not available to the Fund.

The adviser and four of its directors—Chestnutt, Sabel, Currier and Greene—who had been served filed an answer denying most of the non-formal allegations of the complaint and pleading various affirmative defenses. The only one of importance was:

> 27. The Fund has received the benefit of brokerage services equal in value to the brokerage commissions paid by it at the regular, customary and required minimum rates for transactions on national securities exchanges, and the Fund has received the benefit of brokerage services equal in value to brokerage commissions paid by it in accordance with regular and customary rates obtaining in other markets, all in



> accordance with rules and regulations of national securities exchanges and associations authorized and empowered by law to determine brokerage practices, rates and procedures, and this action may not be maintained.

Although the parties had initially demanded a jury trial, this was waived. A pretrial order directed that the issue of liability be tried separately. Various facts were stipulated. These included that until 1971 defendant Stanley L. Sabel was senior vice president, secretary and a director of the Fund, and vice president, secretary, general counsel and a director of the Adviser; that his law firm of Sutton, Sabel & Schupp became counsel to the Fund about 1966, and that Sabel owned 16% of the stock of the Adviser; that Clendon H. Lee, whose wife owned 1% of the stock of the Adviser, was special counsel to and a director of the Adviser, became special counsel to the Fund in 1965, and had acted since 1967 as counsel for the Adviser and the served defendants in this action; and that defendant Currier owned 2% of the stock of the Adviser. The stipulation included facts as to the acquisition of membership in the Pacific Coast Exchange and the reduction of advisory fees through the recapture of commissions by Waddell & Reed, Inc., Investors Diversified Services, Inc., the Channing Complex, and Imperial Financial Services, substantially as stated in PPI, pp. 1314-1316 supra. There was also a stipulation concerning the degree of consideration given to recapture by the directors of the Fund and the advice on that subject by Sabel and Lee, of which more hereafter. There was some narrowing of plaintiffs' contentions and a 17-paragraph statement of defendants' answers.

After trial Judge Wyatt rendered an opinion dismissing the action on the merits, 383 F. Supp. 914. Accepting the principle "that defendants were under a duty by all proper

means to secure for Fund the return of excess brokerage commissions," he concluded it had not been shown "that defendants could have properly secured any return for Fund," 383 F. Supp. at 920. Assuming *arguendo* that *Moses* v. *Burgin* had been correctly decided, he viewed it as distinguishable on the ground that the fund there concerned was a load fund whose shares were sold by an affiliated underwriter, who was qualified as a "dealer" within the NASD definition of that term and who was in fact a member of the NASD entitled to receive customer-directed give-ups on certain regional exchanges until the abolition of such give-ups on December 5, 1968. Recognizing that NASD membership was not required for membership on the Philadelphia-Baltimore-Washington Exchange, Judge Wyatt ruled that such membership[6] "would require defendants to pretend that the new subsidiary was a broker, when in fact it was not, for the purpose of securing a preference over other investors by recapturing a part of the fixed commissions" and that this would have run counter to public policy, 383 F. Supp. 920-21. The plaintiffs have appealed.[7]

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6 Institutional memberships, with some exceptions, were prohibited following the adoption of Rule 19b-2 which ultimately became effective March 29, 1973, under the Securities Exchange Act of 1934, see 17 C.F.R. § 240, 19b-2 (1973).

7 We decline to yield to defendants' urging that we make a "threshold" disposition without reaching the merits, on the ground of plaintiffs' failure to allege with sufficient "particularity" their efforts to obtain action from the directors or their reasons for failing to do so, as required by F.R.C.P. 23.1; cf. *Brody* v. *Chemical Bank*, 482 F.2d 1111 (2 Cir. 1973). Defendants refer to our decision in *Papilsky* v. *Berndt*, 503 F.2d 554 (2 Cir. 1974), as having "carefully reserved the right *after trial* to obtain judgment of dismissal for failure to comply with Rule 23.1" (emphasis in original), Defendants-Appellees' Brief at 31. The most casual reading of *Papilsky* would show that what was said on the subject of reservation was addressed to a situation in which objection had been made before trial and overruled by the trial judge. While the answer in this case made a formal denial of the paragraph of the complaint which sought to show compliance with F.R.C.P. 23.1, no issue of non-compliance was included in defendants' 17 contentions listed in the pre-trial order. We regard the point as having been abandoned.



## III.

Before analyzing the legal issues it will be convenient to update the discussion of administrative developments in Part I of this opinion, which we left with the publication of PPI at the end of 1966. A year later the SEC announced in Release No. 8239 that it had under consideration proposed Rule 10b-10, an effort to implement the suggestion put forward in PPI, which we have quoted, that "it would not be inconsistent with [the] rules [of certain regional stock exchanges] for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the fund." Having identified "its antecedents" in PPI, Release No. 8239 went on to explain that

> the reasoning on which the proposed rule is based is that if, as pointed out [in PPI] a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so. Furthermore, diversion of such commissions to benefit an investment company manager may be viewed as additional compensation to the manager for handling the portfolio transactions of the fund within the meaning of, and in violation of, Section 17(e)(1) of the Investment Company Act. The proposed rule therefore reflects a duty on the part of mutual fund managers as fiduciaries not to use commissions paid by their beneficiaries for the benefit of the fiduciary when practices, procedures, and rules of the markets in which

such fiduciaries act permit their beneficiaries to receive tangible benefits in the form of reduction of the charges now borne by them.

The proposed Rule was as follows:

Rule 10b-10

(1) It shall be unlawful for any registered investment company or affiliated person of such registered investment company* to directly or indirectly, to order or request any broker or dealer:

(a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person *unless* pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to the remittance;

(b) to designate or employ any broker or dealer on any transaction to transmit, execute or clear a transaction or to perform any other function for which compensation is required or made *unless* pursuant to a written contract the full amount of such compensation is required to be paid over to such registered investment company or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to such compensation.



(2) For the purposes of this rule a person is affiliated with a registered investment company if such person:

(a) is an officer, director, trustee, employee, investment adviser, member of an advisory board, depositor, promoter of or principal underwriter for the registered investment company, or

(b) directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with the registered investment company, its investment adviser or principal underwriter, or

(c) directly or indirectly owns, controls, or holds with the power to vote, five per centum or more of the outstanding voting securities of the registered company.

The Release added a highly significant footnote keyed to the initial reference to a "registered investment company":

*Although the proposed rule is couched only in terms of persons who are affiliates of and fiduciaries to investment companies, the principles which are set forth above may be equally applicable to other managers of pooled funds who act in a fiduciary capacity and who are able to reduce the portfolio commissions of their beneficiaries. To the extent that such managers direct give-ups for their benefit, when they are in a position to utilize them for the benefit of beneficiaries, it would appear that under the Federal Securities Laws or otherwise, this use of give-ups other than for the benefit of these beneficiaries would also constitute an improper practice by such fiduciaries. Accordingly, the

> Commission believes that it is appropriate to solicit comment on this issue and will consider whether the proposed Rule 10b-10 should be applicable to other fiduciaries who manage pooled funds.

In the same release the SEC called for comment on a proposal by NYSE directed to its members dated January 2, 1968. The NYSE proposal, although extremely vague, contemplated a volume discount, "continuation of the practice of customer directed give-ups on their own transactions with a limitation on the percentage amount which may be so given-up," and the taking of "steps to prohibit reciprocal practices which result in de facto rebates of NYSE commissions even where those arrangements involve other markets than the NYSE floor, provided that the SEC will aid in prohibiting such practices in other markets." Apparently cheered by NYSE's first indication of willingness to consider a volume discount, the SEC characterized the NYSE proposal as "to a significant extent an alternative approach" to the proposed Rule 10b-10, saying:

> While the New York Stock Exchange proposal and proposed Rule 10b-10 are not mutually exclusive on all points, the New York Stock Exchange proposal is, to a significant extent, an alternative approach. Insofar as the New York Stock Exchange proposal would provide institutional investors with a volume discount while at the same time closing, insofar as possible, the various avenues by which an institutional manager can recoup commissions for the benefit of the fund, it could, depending upon the nature and extent of the volume discount, provide a direct rather than an indirect means by which institutional investors may obtain the benefit of lower charges.



During 1968 there were various communications between the SEC and NYSE, recounted in *Gordon* v. *New York Stock Exchange, supra*, —— U.S. at ——, 43 U.S.L.W. at 4961, which culminated in the establishment of a volume discount for orders exceeding 1,000 shares and other alterations in rates. In a letter proposing the volume discount, NYSE also stated that it would be impossible to determine the impact of the interim schedule so long as give-ups continued. Accepting the NYSE proposals in a letter of August 30, 1968, released as a formal decision "Approving Interim Commission Rate Measures," SEC Chairman Cohen replied:

> Your letter . . . states that [the various exchanges would] "prohibit customer-directed give-ups of work or money in consideration of listed business . . ." We understand that this change is intended to prohibit all forms of customer-directed give-ups, but is not meant to preclude or interfere with non-customer directed interdealer reciprocal business on regional exchanges nor is it designed to prevent the procedures whereby broker-dealer affiliates of institutions may credit or return commissions to institutions with which they are affiliates.

Not predisposed to endure both volume discounts in fixed commissions *and* the system of give-ups by which fixed rate commissions had been evaded, NYSE abolished give-ups effective December 5, 1968 and the regional exchanges followed suit. In anticipation of this the SEC had issued an order on December 3, 1968 directing future mutual fund prospectuses to reflect changed stock exchange rules prohibiting "customer-directed give-ups" but nothing was said about the proposed Rule 10b-10, which presumably had

become unnecessary, or about the qualification mentioned in Chairman Cohen's letter.

The next item is a letter of November 10, 1969 from SEC General Counsel (now Commissioner) Loomis in response to an inquiry about the duties of funds to recapture. Mr. Loomis replied, in pertinent part, as follows, Securities and Exchange Act Release No. 8746, CCH Federal Securities Law Reports ¶ 77,761:

> You first ask whether mutual fund management has a fiduciary duty to acquire a stock-exchange seat directly or through an affiliate, in order to utilize this means to recapture brokerage which in turn will be offset against management charges. We do not believe that management has this duty if in the exercise of its best business judgment management determines that it is not in the best interests of the fund to create such an affiliate. Proposed Rule 10b-10, as published for comment on January 26, 1968, to which you refer, has been withdrawn.
>
> As you suggest, the statements in letters from the Commission to stock exchanges in connection with their adoption of rules abolishing the customer-directed give-ups, that the Commission understood that these rules were not designed to terminate procedures whereby institutions may obtain returns of commissions merely reflected, in our view, that the exchange rules with respect to customer-directed give-ups did not, and were not intended to, terminate the existing arrangements which a few mutual fund organizations have made for the indirect recapture of a portion of their commissions. It is my understanding that this is not presently accomplished by means of customer-directed give-ups, which have been abolished but in other ways, primarily by reciprocal practices. If these reciprocal practices



> are available to fund managements, it did not seem appropriate to foreclose their use to benefit the fund itself.
>
> It should be understood, however, that if mutual fund management does acquire a seat on a regional stock exchange whose rules permit the recapture of commissions paid by the fund through the use of that seat, there may be circumstances under which such recapture could be required and that the management may not be free to simply retain for itself revenues derived from this source. This is particularly likely to be true where the affiliate on the exchange does not execute or clear transactions for the account of the fund, but merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers. . . .
>
> In your letters you suggest various courses of action which the Commission might take with respect to the question of so-called "institutional membership" and other aspects of the commission rate structure. Decisions on these matters will have to await further developments in the inquiries concerning the commission rate structure to which I referred earlier.

Having achieved establishment of the volume discount, the SEC then turned to another objective, bringing about competitive rates on large orders. The history of this endeavor is also recounted in the *Gordon* opinion, —— U.S. at ——, 43 U.S.L.W. at 4962. On February 4, 1972, the SEC issued a Policy Statement on the Future Structure of the Securities Markets, CCH Federal Securities Law Reports No. 409. This wide-ranging statement included several passages bearing on the problems here presented. One was this, pp. 42-43:

[W]e believe that the cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not, even in part, by the existing shareholders of the fund who often derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon the existing shareholders of the fund may violate principles of fairness which are at least implicit in the Investment Company Act.

Finally, the practice of compensating broker-dealers for mutual fund sales by assigning them commission business violates the long accepted precept in investment company regulation that an investor is entitled to know how much was paid to those who sell him an investment. This practice puts the investment company in the position of issuing a prospectus which purports to specify the sales compensation but fails to quantify the additional compensation paid to the customer's broker-dealer in the form of commission business awarded on the basis of success in selling investment company shares.

The Commission believes it should be made clear now that these reciprocal practices must be terminated. When the NASD completes its study of what it considers to be a fair load for the sale of investment company shares, as required by the Investment Company Amendment Act of 1970, it will be in a position to recommend a sales charge which reflects the full incentive appropriate to such sales and which can be fully and explicitly disclosed to the buyers of such shares. To accomplish this the Commission is sending a letter to the NASD setting forth the Commission's views and requesting the NASD to direct its members to discontinue the use of reciprocal portfolio brokerage for the sale of investment company shares. If such a response is not forthcoming, the Commission will then consider rule-making to accomplish the desired result.



Another was this, p. 44, 46-49:

*Institutional Membership*

The question of institutional membership on national securities exchanges is an exceedingly difficult one, and in dealing with it we have painstakingly reviewed the alternatives presented to us. It is the Commission's firm view that, as a central market system develops, it should have at its heart a corps of professional brokers and market makers serving investors. Moreover, in light of the strain which the magnitude and tempo of the transactions of financial institutions currently place on the securities markets, it is our view that institutions should not be permitted to deal through brokerage firms established principally to handle their own transactions but should be required to deal through brokers dedicated primarily to serving and having fiduciary obligations to a broad investing public. Thus, as a general rule, the Commission believes that membership in the central market system should be open only to those who meet qualifying standards and who have the primary purpose of serving the public as brokers or market-makers . . .

Certain regulatory problems arise out of the relationships created by institutional membership. The first stems from the existence of a structure of fixed minimum commissions. So long as such a structure exists, large investors should not, by virtue of their economic power and size, be entitled to obtain rebates of commissions not available to other investors. While

fixed minimum commissions exist, they should apply to all investors, and an exception should not be given to a particular person. Institutional membership, however, provides a vehicle for obtaining rebates, either directly or indirectly.

Second, institutional membership may result, to a greater or lesser degree depending on the circumstances, in the use of exchange membership for private purposes rather than for the purpose of serving the public in an agency capacity or otherwise performing a useful market function. In part, this problem is similar to that discussed in the preceding paragraph: the problem of using exchange membership as a means of obtaining a reduced commission rate. But the problem of using exchange facilities for private purposes is broader in scope than the rate question. For we believe that membership in the market system should be confined to firms whose primary purpose is to serve the public as brokers or market makers. Stock exchanges are affected with an overriding national interest which demands that they act to maintain and improve the public's confidence that the exchange markets are operated fairly and openly. The public should have the assurance that a member of an exchange is dedicated to serving the public, and membership by institutions not predominantly serving non-affiliated customers should not be permitted to cloud this objective.

Our authority to deal with these problems derives from the stated purposes of the Securities Exchange Act and is most specifically expressed in Section 19(b) of such Act which deals with "such matters as . . . the fixing of reasonable rates of commission, interest, listing, and other charges . . . and . . . similar matters".



Insofar as institutional membership is employed primarily as a vehicle for obtaining recapture of commissions, as in the first situation described above, it should not be allowed to exist. Membership under those circumstances is plainly in conflict with the concept of fixed minimum commissions and results in exchange membership solely for private purposes. We believe that such membership and practices which permit the rebate or recapture of commissions, directly or indirectly, should be eliminated. The Commission intends to act promptly to terminate this type of membership. The regional exchanges, as vital elements of the central market system, should compete on their merits as market components and should not need this special competitive tool.[8]

In response to this Report, see ¶ 78,906 Fed. Sec. L. Rep. (1972), NASD proposed a rule to abolish reciprocals; this rule became effective July 15, 1973, see ¶ 79,414 Fed. Sec. L. Rep. (1973). By contrast, the validity of the SEC's conclusions on the evil of institutional memberships, which were quite at variance with the earlier pronouncements we have quoted, was vigorously challenged, notably by Elkins Wetherill, president of the PBW Stock Exchange, see Wetherill and Hendon, Institutional Membership and the Experience of the Philadelphia-Baltimore-Washington Stock Exchange, 13 Boston College Ind. & Com. Rev. 959 (1972). Senator Williams introduced a bill, S. 3169, 92d Cong. 2d Sess. (1972), which would remove the SEC's power to restrict institutional membership until one year

8 Commissioner Owen dissented from so much of the report as would allow an institution to establish or acquire a broker-dealer if the latter did business "predominantly with public investors." He thought doing business for the parent should be prohibited since any such relationship "permit[s] of a rebate situation, either directly or indirectly," at 61-62.

after the effectiveness of a rule requiring negotiated rates on all transactions exceeding $100,000. Nevertheless, the SEC promulgated Rule 19b-2, effective March 29, 1973, forcing every exchange to "require every member of such exchange to have as the principal purpose of its membership the conduct of public business."[9]

The story finds its end in the Securities Act Amendments of 1975,[10] 89 Stat. 97, which, of course, were not available to Judge Wyatt. Section 11 of the Securities Exchange Act was amended so that, subject to certain exemptive powers of the SEC, and exceptions not here material, exchange transactions for one's own account or that of an associate, would be unlawful, subject to a three-year phasing out provision for persons who were exchange members on May 1, 1975, 89 Stat. 110. Section 6 was also amended to provide that "no national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members," subject to a one year extension for floor brokers and odd-lot dealers and a "fail-safe" provision for the reinstitution of such schedules if the SEC approved, 89 Stat. 107.

### IV. *The Basis of Liability.*

Plaintiffs assert two different theories of liability for defendants' failure to make efforts to recapture. One is

9 A member was to be deemed to have such a purpose only if 80% of its securities business was "effected for or with persons other than affiliated persons" or was one of eight described categories. PBW challenged the validity of the rule, but this challenge was dismissed on jurisdictional grounds, *PBW* v. *SEC*, 485 F.2d 718 (3 Cir. 1973), *cert. denied*, 416 U.S. 969 (1974).

10 S.470, the predecessor of the Amendments ultimately enacted, would have continued institutional memberships so long as fixed rates were being phased out, and would have required the SEC to withdraw Rule 19b-2 during this period. Sen. Rep. No. 93-187, 93 Cong. 1st Sess. (1973).



that such efforts were required by Fund's certificate of incorporation; the other is that they were required as a matter of fiduciary duty—or perhaps more accurately that management was obliged as a matter of fiduciary duty to put the problem fairly before the independent[11] directors. While both theories demand some further showing of the possibility and legality of recapture, we observe that the obligations entailed by the contract theory might well be more severe than those entailed by the theory of breach of fiduciary duty.

The contract argument is as follows: The Certificate of Incorporation of the Fund provided in ¶ 3(c)(iv) that:

11 Section 5 of the Investment Company Amendments Act of 1970 strengthened the requirement that at least 40% of the directors of an investment company not be "affiliated persons" by substituting the term "interested persons," 15 U.S.C. § 80a-10(a). "Interested persons" includes, in addition to "affiliated persons," "members of the immediate family of such persons and persons who have beneficial or legal interests as fiduciaries in securities issued by the investment adviser," "any broker-dealer" "and affiliated persons of any such broker dealer," and legal counsel for the Fund or the adviser. Sen. Rep. No. 91-184, 3 U.S. Code Cong. & Adm. News 4928 (1970). An "affiliated person" is:

> (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

15 U.S.C. § 80a-2(a)(3). Since the expanded requirement, although it does affect a present defendant, does not decisively tip the interested/disinterested balance, we shall use the term "independent" throughout to indicate persons either not "affiliated" prior to the 1970 amendments or not "interested" thereafter.

> The public offering price of each share of capital stock shall be the net asset value then in effect plus the load or commission charged adjusted to the nearest full cent. Any load or commission for the distribution of shares of the Corporation by a distributor may be fixed from time to time by the By-Laws of the Corporation, but shall in no event exceed 8½% of the public offering price, nor shall the consideration per share to be received by the Corporation after deduction of such load or commission be less than the net asset value. . . ."

The by-laws made no provision for a sales load or commission. A direct payment of commissions from the Fund's treasury to brokers selling shares of the Fund would thus have violated the charter. There is no significant difference when the Fund allows selling brokers to receive commissions which it could have "recaptured." A similar argument, made by the same counsel, was accepted in *Moses* v. *Burgin, supra,* 445 F.2d at 374.[12]

Although the argument is not without force, we think it presses too far. The term "net asset value" is one of art in the mutual fund industry and is elaborately defined in the certificate of incorporation. The objective of the charter provision was to prevent dilution of per share net asset value by the issuance of new shares at a discount; defendants' failure to recapture part of the commissions on portfolio transactions does not result in such dilution. Plaintiffs' real complaint is not that new shareholders did not pay net asset value but that the Adviser, for selfish

12 A comment on *Moses* raises the question why, if this theory were sound, the court went on with an extensive discussion, 445 F.2d at 377, et seq., of management's duty to make full disclosure to the unaffiliated directors and the apparent resting of liability upon that ground. *Butowsky, supra* n.1, 749-50 (1971).



motives, refrained from handling portfolio transactions in a manner that would have diverted a portion of the commissions to itself, with an attendant decrease in the advisory fee—in substance a charge of breach of a fiduciary duty resulting in corporate waste.

When we pass to the theory of breach of fiduciary duty, we are confronted initially with the question of the applicable standard. The *Moses* court predicated federal jurisdiction on § 36 of the Investment Company Act prohibiting "gross misconduct or gross abuse of trust," 445 F.2d at 373, and seemingly also held, 445 F.2d at 384, that defendants' conduct violated that standard as the First Circuit had interpreted it in *Aldred Investment Trust* v. *SEC*, 151 F.2d 254, cert. denied, 326 U.S. 795 (1946). Taking a less expansive view of § 36 as originally enacted, we have held that the Act implicitly established a federal standard of fiduciary duty in respect of dealings between a mutual fund and its adviser, *Brown* v. *Bullock*, 294 F.2d 415, 421 (2 Cir. 1961); *Rosenfeld* v. *Black*, 445 F.2d 1337, 1345 (2 Cir. 1971), a duty which the 1970 amendment makes explicit "with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser"—the situation presented here.

We agree with the First Circuit, 445 F.2d at 376, that under the scheme of the Investment Company Act an investment adviser is "under a duty of full disclosure of information to . . . unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund"—a situation which occurs much more frequently in the relations between a mutual fund and its investment adviser than in ordinary business corporations, see *id.;* Comment, Duties of the Inde-

pendent Director in Open-End Mutual Funds, 70 Mich. L. Rev. 696, 698-99 (1972); Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. of Pa. L. Rev. 1058, 1060-61 (1967). Chief Judge Aldrich went on to quote from the SEC's decision in *Imperial Financial Services, Inc.*, CCH Fed. Sec. L. Rep. ¶ 77,287 at 82,464 (1965), as we do in the margin.[13] He emphasized that the communication of information must be "effective," bearing in mind that the independent directors are not full-time employees and that "neither their activities nor their experience" may be "primarily connected with the special and often technical problems of fund operation." He concluded:

> If management does not keep these directors informed they will not be in a position to exercise the independent judgment that Congress clearly intended. The only question can be whether the matter is one that could be thought to be of possible significance.

Although the Fund apparently would have qualified for the single unaffiliated director exception of § 10(d), it had never availed itself of this.[14] One independent director, Richard Radcliffe, who served from 1958 until December, 1969, was highly sophisticated in investment company mat-

13 The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company.

14 We reject the suggestion implicit at some parts of defendants' brief that adequate knowledge by one unaffiliated director would suffice even when a fund has opted to have several; shareholders rely on what the fund has done rather than on a lesser requirement, of which the Fund did not avail itself.



ters. None of the others appear to have been, although they had experience in other forms of business.[15]

The data yielded by the record on the subject of disclosure is as follows:

The pre-trial order states:

> Subsequent to the filing of an action by these identical plaintiffs in this Court, against these defendants and others in January, 1967, (67 Civ. 60) which claimed, among other things, impropriety in connection with brokerage commissions charged on Fund portfolio transactions, Messrs. Sabel and Lee advised all of the directors of the Fund and the Adviser on numerous occasions, including meetings of such Boards, that no impropriety had been found in connection therewith. On or about February, 1968, upon the issuance by the Securities and Exchange Commission of its 1934 Act Release No. 8239 dated January 26, 1968 proposing a new Rule 10b-10 (which proposal the Commission later withdrew), Messrs. Sabel and Lee specifically advised all of the directors of the Fund and the Adviser that the suggested form of "recapture" contained in such

15 The following chart represents the composition of the Fund's board of directors during the relevant period:

1963 1964 1965 1966 1967 1968 1969 1970 1971 1972 1973

| | | | |
|---|---|---|---|
| George A. Chestnutt, Jr.* (affiliated) | | | (interested) |
| Stanley Sabel* (affiliated) | | | (interested) |
| John Currier* (unaffiliated) | | | (interested) |
| Eliz. Sullivan (affiliated) | Warren K. Greene* (affiliated) | | (interested) |
| Richard Radcliffe (unaffiliated) | Wm. Semmes (disinterested) | | |
| Frank G. Fowler (unaffiliated) | | | (disinterested) |
| Francis L. Veeder (unaffiliated) | | | (disinterested) |
| P. Murtaugh (unaffiliated) | Wm. May (unaffil.) | vacant | Eugene Ulrich (disinterested) |

* Defendants who were served

proposed, but never adopted, new Rule 10b-10 by its express terms applied only to "dealer-distributed funds", rather than a no-load fund such as the Fund which has no "distributor" or "underwriter", and Messrs. Sabel and Lee advised that the question of possibility of recapture of brokerage commissions which the Fund is compelled to pay upon execution of portfolio transactions does not arise.

There are no writings reflecting any discussions or deliberations by any of the Fund's directors with respect to recapture.

Plaintiffs also offered defendants' answer to their Interrogatories Nos. 5, 6 and 7, which read as follows:

5. (a) State whether at any time from January 1, 1963 to the present any of the defendants discussed with or otherwise informed any unaffiliated directors of the Fund of the possibility of recapturing the Fund's brokerage commissions in any manner whatsoever, including but not limited to membership on regional exchanges, or N.A.S.D. affiliation by Chestnutt Corp. (the "investment adviser").

(b) If the answer to (a) above is in the affirmative, identify and describe each such discussion and all memoranda, minutes and other writings referring to such discussions.

6. State whether at any time from January, 1963 to the present any discussion of the possibility of Exchange membership for the Fund, the investment adviser or any affiliate of the Fund or the investment adviser was discussed between or among any directors of the Fund or the investment adviser, and if so identify and describe each such discussion, including the time, place and persons present, and all memoranda, minutes or other records referring to such discussions.



7. (a) Identify and describe, by time, place and persons present, all meetings of the boards of directors of the Fund or the investment adviser from 1963 to the present at which the possibility of recapturing brokerage commissions was discussed.

(b) State whether there is any existing record of such discussions, including but not limited to memoranda, minutes, correspondence or tape recordings.

The answer, omitting one paragraph which does not differ in substance from the first paragraph quoted from the pre-trial order, was as follows:

All directors of the Fund knew and have always known since becoming directors that the Fund was a "no-load" Fund and sells its shares directly by mail, and to some extent upon receipt of telephone orders, to subscribers who become Fund shareholders by such direct purchases without the intervention of, or any commission payable to, any broker or dealer, or underwriter. Accordingly, the Fund differs from most other mutual funds in that it is not "dealer-distributed", nor is there any "underwriter", nor is there any broker or dealer affiliated with the Fund or affiliated with the Adviser or affiliated with any officer or director of either and all directors of the Fund have known these facts at all times.

No director has suggested that the Adviser divert its resources, efforts and talent from advice and management of investments to enter the new, untried and risky business of public brokerage or underwriting as one of many prerequisites to becoming a member of an exchange or of the N.A.S.D. The management of

the Adviser understands that unaffiliated directors of the Fund are and have been categorically opposed to any brokerage or underwriting activity by the Adviser or such activity by any new brokerage or underwriting entity which might be created by or at the instance of the Adviser, because of the inherent conflict of interest and the diversion of attention and resources from investment advice and management.

All Fund directors have had brought to their attention the February 1972 statement by the Securities and Exchange Commission relating to the future structure of securities markets, including the separate statement by its senior member, Commissioner Owens, expressly disapproving any brokerage functioning whatever by an affiliate of a mutual fund on its behalf, as constituting a clear conflict of interest, as well as the majority text suggesting the propriety of stock exchange membership and brokerage functioning where the brokerage activity was preponderantly for the public, together with informal Commission statements indicating that any brokerage whatever for an affiliated mutual fund should be permitted only where 80% of the brokerage business was with the general public as distinguished from any affiliated mutual fund. The Adviser, upon advice of counsel, and in view of widely varying contentions advanced in legislative committees, conflicting views within the Securities and Exchange Commission, and widely varying views within the securities industry with respect to market structure, commission rate structure, applicability of antitrust laws, access to markets, and a variety of other matters, has in 1972 caused incorporation papers to be drawn for a possible brokerage subsidiary of the Adviser, which incorporation papers have not been filed pending clarification of legislative and



practical considerations in the future, and the unaffiliated directors have been so informed . . .

Defendants do not believe that there are any papers or writings referring to any such discussion but defendants are continuing to search for any. Such advice from counsel has been on a continuing basis, including conferences with defendants in connection with the defense of both actions brought by these plaintiffs and in connection with periodic review of the Fund's Prospectus.

The testimony of the independent directors indicated nothing more in the way of disclosure. Director Radcliffe endorsed the language in prospectuses of two T. Rowe Price funds[16] and said that it would be improvident to

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16 The passage from the Rowe Price New Era Fund, Inc. prospectus dated May 1, 1973, Radcliffe endorsed read:

> The Securities and Exchange Commission has recently adopted a rule which requires national securities exchanges to grant membership access to institutions, which for this purpose would include the Fund and [the Adviser], provided that the primary purpose of membership is to transact public business. [The Adviser], which has since its inception taken the position that the business of rendering investment supervisory services should be separated from the brokerage business, has informed the Fund that, in its opinion, the possible advantages of exchange membership are insufficient to overcome the disadvantages. Exchange membership would have the effect of reducing brokerage costs of the Fund, either directly (if the Fund were the member), or through a "recapture" arrangement (if [the Adviser] were the member); however, it would also divert the energies and financial resources of [the Adviser] from the business of rendering investment supervisory services to the conduct of a public brokerage business, and would create a potential conflict between the desire to reduce commission costs and the possibility that better price and execution could be obtained elsewhere. In addition, the savings which might result from exchange membership would not necessarily exceed the savings to be attained through negotiated commissions on transactions through unaffiliated brokers. After considering the possible advantages and disadvantages of exchange membership in light of the views of [the Adviser], the Fund's Board of Direc-

participate in the brokerage business. Director Ulrich, who joined the board only in 1971, considered it a "conflict of interest" for the adviser "even to be connected with brokerage." Director May, who left the board in 1965, never recommended the formation of a brokerage firm—something plaintiffs likewise have not suggested. Director Currier, whose status changed from "unaffiliated" to "interested" on December 14, 1970, by virtue of § 5 of the Investment Company Act Amendments Act of 1970, see fn. 11, also professed to be opposed even to the possibility of having the adviser participate in brokerage. With the possible exception of Director Radcliffe (as to whom see note 16), it is not clear at all that any of these witnesses thoroughly understood the forms of recapture which the plaintiffs propose.

The testimony of the other directors was as follows: In answer to a question whether counsel had advised that forming an NASD affiliate or securing an "introducing membership" on a regional exchange was illegal, Chestnutt said they had advised against it "because it was fraught with self-dealing, with temptations of various sorts." Mr. Sabel had "repeatedly" used the hortatory expression "shoemaker stick to your last," instructing Chestnutt to stay out of the brokerage business and stick to the thing he knew best, namely, analyzing the market. When asked where the self-dealing would be if he formed an affiliate that merely received commissions and paid

tors, including all of the directors who are not affiliated with [the Adviser] has determined that exchange membership would not be in the best interests of the Fund or its stockholders.

As applied to this case, this passage was misleading in some respects. In addition to the reliance on negotiated rates, which were not possible for most of the period here in question, the requirement that exchange members be primarily engaged in public business dates only from March 29, 1973. Director Radcliffe nevertheless appears to have assumed that recapture was possible only by a full-fledged brokerage house.



them back to the Fund, Chestnutt said that he did not know this was possible. Asked whether he had ever made any inquiry of the NASD or the PBW Exchange, he announced that NASD meant National Association of Securities Dealers and that it hadn't occurred to him that "it was a national association of check drop artists." Greene, vice president of the Fund and of the Adviser, thought the adviser was ineligible to be a member of NASD. Sabel testified that a copy of the 346 page PPI report had been sent to each director and that "it" had been discussed several times but that there had been no discussion of the recapture provision because, as Sabel had advised, "this didn't apply to us."

This does not add up to the effective communication of a problem to the independent directors mandated by *Moses*. To be sure, we do not have in this case direct suggestions from staff of the SEC such as those discussed in *Moses*, *supra*, 445 F.2d at 377. But this goes mainly to the question whether the Adviser had any duty of disclosure to the independent directors prior to issuance of PPI. When that was issued, Sabel took it on himself to decide that the SEC's recommendations did not apply to a no-load fund because the language on pp. 172-73 spoke in terms of "adviser-underwriters, all of whom are NASD members," although the basic principle stated in the summary on p. 1329 did not.[17] There is nothing to indicate that Sabel asked the SEC whether its comments had an application to no-load funds or made any inquiry as to the possibility of the Adviser's or an affiliate's obtaining NASD membership or of achieving recapture by membership on a regional exchange. There was even less basis for counsel's unceremoniously brushing aside proposed Rule 10b-10. While the introduc-

17 Also the footnote appended to the statement on p. 172 spoke of use of "a broker-dealer affiliate"—a method equally available to no-load funds.

tory material began with a quotation from p. 173 of PPI, with its reference to "adviser-underwriters, all of whom are NASD members" (although with the accompanying footnote, see note 17), the next paragraph was worded more broadly and the proposed rule was in no way limited to dealer-distributed funds. Sabel's view went in the direction that his status as an officer, director and 14% owner of the Adviser led him. Reliance on such obviously casual advice from a lawyer having a personal stake adverse to the shareholders affords no protection unless it is right—in which event it is unnecessary to assert the defense of reliance.

PPI had raised a question which, in the language of *Moses*, 445 F.2d at 377, "could be thought to be of possible significance" and on which the interests of the Fund and the Adviser were in clear conflict. Congress had mandated independent directors in order "to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs." S. Rep. No. 91-184, 91st Cong. 1st Sess. (1969), reprinted in 3 U.S.C. Cong. & Adm. News, 91st Cong. 2d Sess. at 4927 (1970). The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.[18]

If this had been done and the independent directors had concluded that, because of legal doubts, business considera-

18 This was done in *Moses* but the court found that counsel had not been sufficiently informed.



tions or both, the Fund should make no effort at recapture, we would have a different case.[19] But when there has been inadequate communication to the independent directors, it is no defense to the Adviser and those exercising control over it that a decision not to recapture, taken after proper communication, would have been a "reasonable business judgment."

Our agreement with the First Circuit in this regard is a proper projection of *Mills* v. *Electric Auto-Lite Co., Inc.*, 396 U.S. 375 (1970). Apart from the salutary prophylactic effects of such a rule, courts can have little confidence in *post litem motam* expressions by independent directors as to what they would have done if management had put all the facts before them. Under the best of circumstances there is bound to be doubt about the independence of the "unaffiliated" or now the "disinterested" director, see Note, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich. L. Rev. 696, 701 (1972). These should not be enhanced by recognizing a *post hoc* reconstruction of mental processes as a defense.

We therefore conclude that liability exists with respect to the Adviser and to defendants Chestnutt, Sabel and Greene. Under the principle laid down in *Moses*, *supra*, 445 F.2d at 384, we would see no basis for imposing liability on directors who were not interested. In this respect defendant Currier is a special case; although he could be counted as unaffiliated until December 14, 1970, because of his small stock ownership in the Adviser he was in fact not disinterested. We therefore include him with the defendants held to be liable. While we do not rule on the apportionment of liability, equity would suggest the imposition of primary responsibility on the Adviser, which profited from the failure to recapture.

19 We do not read Mr. Loomis' letter of November 10, 1969, see p. 14 *supra*, as going beyond this.

V. *The Possibility of Recapture.*

The foregoing conclusion would not, of course, lead to reversal if defendants are right in saying that recapture was impossible or illegal. In this section of the opinion we will deal with the possibility of recapture, in the next section with its legality.

The record leaves little doubt that if the Adviser or an affiliate could have achieved NASD membership, it would have been entitled to give-ups on transactions executed on the PBW and Pacific Exchanges[20] (until the abolition of give-ups in December, 1968), to discounts of 25% on the Pacific Coast Exchange, and also to tender offer fees.[21]

Judge Wyatt was of the view that neither the Adviser nor an affiliate could have achieved NASD membership. The qualifications for NASD membership are as follows:

> Any broker or dealer authorized to transact and whose regular course of business consists in actually transacting any branch of the investment banking or securities business in the United States, under the laws of any State and/or the laws of the United States, shall be eligible to membership in the Corporation.

Broker is defined as follows, this being an elaboration of the definition in § 3(a)(4) of the Securities Exchange Act:

> The term "broker" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

20 Give-ups of 25% were permitted on the PBW Exchange from November, 1965 to June, 1966 when they were raised to 40%. The Pacific Coast Exchange permitted give-ups of 25%.

21 The maker of a tender offer frequently agrees to pay a fee to any NASD member named by the tendering shareholder.



Judge Wyatt thought the Adviser or an affiliate in directing the sale of securities from or the purchase of securities for the Fund's portfolio would not be transacting any branch of the securities business or effecting transactions in securities. More particularly it would not be doing the latter "for the account of others" since "the suggestion is that it act for the Fund alone. . . ." *Moses* presented a different case since Crosby, the distributor of the fund in that case, was a "dealer" which was entitled to be and indeed was a NASD member.[22]

Agreeing with the last point and admitting some force in the others, we do not find the provisions so unambiguous as to justify the defendants' thinking that NASD membership was unattainable. The Adviser and the Fund are distinct entities, one owned by the management group and the other by the investors. Many brokers have nothing to do with the execution or clearing of orders, functions which they confide to others. So far as concerns the reference to "others" rather than "another," the Adviser in the present case originates transactions for many investors in addition to the Fund; if that were not enough, something might be said for piercing the corporate veil and regarding the Adviser as acting "for the account of" the Fund's shareholders. Perhaps most important of all, such few SEC

22 We need not consider whether a mutual fund which sells its own shares without an underwriter is a "dealer," defined by the NASD as

> any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

releases and court decisions as exist point to a construction of the term "broker" which could well include an adviser placing buy and sell orders for the portfolio of a mutual fund. See Distributions of Variable Annuities by Insurance Companies: Broker-Dealer Registration and Regulation Problems under the Exchange Act of 1934, Exchange Act Release No. 8389, Fed. Sec. L. Rep. ¶ 77,594 (1968) (in the context of § 15(a)(1) of the Securities Exchange Act); *Fogel* v. *Chestnutt*, Fed. Sec. L. Rep. ¶ 92,133 (S.D. N.Y. 1968) (construing "broker" for purposes of jurisdiction under § 44 of the Investment Company Act); see also 2 Loss, Securities Regulation 1295-96 (1961); 5 *id.* 3355-56 (1969).

In order to show that the Adviser would have obtained a favorable reception if it had approached the NASD, plaintiffs offered the deposition of Lloyd J. Derrickson, the Senior Vice President and General Counsel of NASD; formerly outside counsel, beginning in 1958, he had been with NASD since 1962. The judge rejected Derrickson's testimony as "puzzling" and "not clear." While there are statements in cross-examination that give some comfort to the defendants, the final question and answer ring loud and clear:

> Q. Mr. Derrickson, if you had received an application from anyone saying that they wanted to become a member of the NASD for the sole purpose of receiving give-ups and crediting those give-ups against advisory fees charged by such applicant to a fund that it was advising, would the NASD have refused that application?
>
> Mr. Lee: Objection to the form of the question.
>
> The Witness: No, I don't think we would have refused it.



The rejection of the testimony thus was based not so much on contradictions within it as on the judge's disagreement with it as a correct interpretation of NASD's rules, a disagreement stemming in considerable measure from his view that it would have been "deceptive and improper" for the Adviser or an affiliate to have become a NASD member and therefore entitled to give-ups and discounts. The latter, however, is a separate issue, to be discussed below. Since the NASD's rules are fairly susceptible of the construction urged by plaintiffs, the testimony of the NASD's general counsel that the organization would have so interpreted them, carries the day for the plaintiffs on the issue whether NASD membership was achievable. Cf. *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965).

The second method of recapture suggested by plaintiffs was through membership in the PBW Exchange by the Adviser or an affiliate. The PBW Constitution states, § 13-2, that:

> Only a corporation whose principal corporate purpose is the transaction of business as a broker or dealer in securities may be registered as a member corporation.

However, the testimony of Elkins Wetherill, president of the PBW Exchange, was unequivocal that an affiliate of the Adviser could have become a member of the PBW Exchange. As such it could have received a substantial portion of commissions as an introducing broker,[23] perhaps as much as 80%, and could have credited these

23 Such a member would merely channel the Fund's orders to executing brokers. Thus the Loomis letter, *supra* pp. 13-14, speaking in the context of the abolition of give-ups, notes:

> It should be understood, however, that if mutual fund management does acquire a seat on a regional stock exchange [recapture may be required]. This is particularly likely to be true where the affiliate on the exchange does not execute or clear transactions for the

against the advisory fee. At least until the abolition of reciprocals on July 15, 1973, the member could also obtain PBW Exchange business from NYSE brokers in return for placing orders with them for execution on that exchange. An exhibit showed that on March 5, 1973, PBW had 49 institutional members, including some nine who appear to have been affiliates of advisers or distributors of mutual funds. As indicated, Judge Wyatt did not dispute that an affiliate of the adviser could have become a member of the PBW Exchange until March 15, 1973, but held this would have run counter to public policy.

In light of its holding that neither the Adviser nor an affiliate could have become a member of NASD, the district court did not find occasion to discuss the third possibility of recapture suggested by plaintiffs, namely, the recovery of tender offer fees. There seems to be little doubt that once NASD membership was obtained this would have been possible. SEC Exchange Act Release No. 10102, CCH Fed. Sec. L. Rep. ¶ 79,327 (1973), recognized this possibility and reminded fund advisers that where such fees were recovered, they must inure to the benefit of the funds.[24]

### VI. *The Legality of Recapture.*

An *amicus* brief on behalf of Lord, Abbett & Co., investment adviser and principal underwriter for several investment companies, and a defendant in *Papilsky* v. *Berndt*,

account of the fund, but merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers.

See also *In the Matters of Provident Management Corp., et al.*, CCH Fed. Sec. L. Rep. ¶ 77,937 n.10 (1970).

24 This release, which says that a fund manager may have "an obligation to name an affiliated broker" to receive such solicitation fees, suggests that the SEC perceived no difficulty in or objection to such an affiliate's becoming a NASD member.



(S.D.N.Y. 71 Civ. 2534), tried before Judge Frankel, maintains that even if the recaptures suggested by plaintiffs were attainable, they would have been illegal[25] as infringing the minimum commission and anti-rebate rules of the PBW and Pacific Coast Exchanges.[26]

25 With respect to tender offer fees, the *amicus* brief contends that the adviser's passing these on to a fund would violate (a) Article III, § 24, of the NASD's Rules of Fair Practice, as held by the district court in *Moses* v. *Burgin*, *supra*, 316 F. Supp. at 48, (b) the Williams Amendment to the Securities Exchange Act, § 14(d)(7), and (c) the SEC's rule 10b-13. We disagree. *Amicus* also points to a proposed amendment to 10b-13, published in Securities Exchange Act Release No. 9920 (1972), which would have made recapture unlawful. The SEC would scarcely have proposed this if recapture was already unlawful. The SEC never adopted the amendment; instead it issued Release No. 10102 discussed in n. 24 *supra*.

26 The Constitution of the Pacific Coast Exchange provides:

> Commissions shall be charged and collected by members and member firms upon the execution of all orders involving the purchase or sale of securities admitted to dealings on the Exchange for the account of others. Commissions shall be charged and collected pursuant to rules and regulations prescribed by the Board of Governors and shall be at rates not less than those established by said Board. Commissions shall be net and free from any rebate, return, discount or allowance in any shape, manner, method or arrangement direct or indirect.

The Constitution of the PBW Exchange provides:

> Sec. 1. Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for the account of members or of nonmembers of the Exchange, of securities admitted to dealing upon the Exchange, except under such Rules as may be adopted by the Board of Governors with respect to special offerings and except as herein further expressly provided; these commissions shall be at rates not less than the rates in this Article prescribed; and they shall be absolutely net and free from any rebate, return, discount, or allowance, in any shape or manner, or by any method or arrangement, direct or indirect.
>
> No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein established, or any portion of a profit, shall be given, paid or allowed, directly or indirectly, or as a salary or as a portion of a salary, to any person or persons for business sought or procured for any member, member firm or member corporation of the Exchange, except as herein expressly permitted.

Two preliminary observations are in order. *Amicus* greatly relies on decisions construing substantive provisions in statutes like the Interstate Commerce Act, 49 U.S.C. § 2, 10, and the New York Insurance Law § 188, 209, 273; but the closest the Securities Exchange Act comes to such a provision is the somewhat back-handed direction in the Maloney Amendment, § 15A(b)(8), that the SEC shall not permit registration of a national securities association unless its rules "are not designed to permit unfair discrimination between customers or issuers." While it is doubtless true, as urged by *amicus*, that exchanges and their members are under a duty to comply with their constitutions and rules filed with the SEC, an exchange has a substantial degree of power to interpret its own rules. Officers of both the PBW and Pacific Coast Exchanges testified that these exchanges did not consider give-ups to affiliates of an investment adviser, discounts (in the case of the Pacific Coast Exchange) or institutional membership (in the case of the PBW Exchange) to constitute violations of their anti-rebate rules.

The second preliminary observation is this: A good deal of the *amicus* brief is devoted to arguing that even if certain methods of recapture were not in fact illegal, counsel could have entertained legitimate doubts of their legality. Such an argument must fail in this case for the reason stated in Part IV of this opinion. If counsel for the Adviser or the Fund entertained doubts as to the legality of various methods of recapture, the *pros* and *cons* could and should have been put to the independent directors, who would then have been able to take legal advice of their own. If, after an independent investigation, they had concluded there was a serious risk of illegality, that might have been an end to the matter. But this did not occur.

Approaching the issue of illegality, we start from the fact that none of the arrangements would have resulted in



the Fund's paying less than the stipulated commission rates; the alleged "rebate" to the Fund consists in the fact that the Adviser, either directly or by a commensurate reduction in the management fee, would pass on the Fund, in exercise of his fiduciary responsibilities, whatever share the Adviser gained in commissions incurred by its transactions for the Fund. While it is surely true, as argued on behalf of *amicus*, that a rebate can arise where a user of services pays the full rate and receives other additional goods or services at less cost than their full value, this principle should not be mechanically transposed to every situation. The reason why executing brokers would have been willing to share commissions with the Adviser was because they were being relieved of the costs entailed in serving smaller customers. Viewed in another way, recapture by a fund was a method, then the only available method, for avoiding the payment of advisory and selling costs exceeding those stipulated in its management contracts. The situation was not one in which recapture would result in an adviser's obtaining services at less than cost whereas others paid the full cost; such unfairness as there was in recapture lay in the fact that advisers to mutual funds were not the only customers who should have benefitted from the size of their orders. Moreover as to this there was evidence that, as stated in PPI, 108-109, "Investment advisers who are also broker-dealers often reduce advisory fees charged nonfund clients by a specified portion of the brokerage commissions generated by their nonfund advisory accounts or otherwise take them into account in setting advisory fee rates for nonfund clients."

Weight should also be given to the views then entertained by the SEC. That body would hardly have suggested that "Under existing commission rate structures, mutual fund shareholders could derive greater benefits from their brokerage commissions if the give-up portions of the com-

missions were transmitted to the funds themselves or their adviser-underwriters for the purpose of reducing management costs," as it did in PPI, p. 16, if it had thought this arrangement involved an illegal rebate. It would hardly have proposed a rule requiring an adviser not to order or request a give-up unless this was paid over to the investment company or the advisory fees were correspondingly reduced, as it did in Release No. 8239 (1968), if it had conceived that the rule would have mandated illegal conduct.[27] The SEC would not have required Provident Management Corp. and Porteous, its president, to turn over amounts recaptured on the PBW Exchange to the investment company for which they acted, see *In the Matter of Provident Management Corp., et al.*, CCH Fed. Sec. L. Rep. ¶ 77,937 (1970), if the Commission had considered that it would be sanctioning an illegal rebate.[28]

Finally, we have on this point the authority of *Moses* v. *Burgin, supra*, 445 F.2d at 381-82.[29] With evidence that the respective exchanges would not consider their anti-

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27 Note also the footnote quoted on p. 11 *supra*, indicating that the principles set forth in the proposed Rule 10b-10 "may be equally applicable to other managers of pooled funds who act in a fiduciary capacity and who are able to reduce the portfolio commissions of their beneficiaries."

28 See also the *amicus* memorandum filed in *Gross* v. *Moses*, 67 Civ. 4186 (S.D.N.Y., 1971), where, as stated in the Report of the Senate Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, Sen. Doc. No. 93-13, 93rd Cong. 1st Sess. p. 84 n.111 (1973), "the SEC took the position that where recapture of commissions is available through regional exchange membership, mutual fund management must at least make a bona fide judgment as to whether to establish a brokerage affiliate to recapture commissions for the fund."

29 On the rebate issue, as distinguished from that of the possibility of NASD membership, it can make no difference that *Moses* was concerned with a load fund. Neither does it matter that the illegality discussion in *Moses* concerned only recapture through NASD membership and did not discuss recapture through membership on an exchange; the principles would be the same.



rebate rules to have been violated by recapture for the benefit of a fund, the court of appeals refused to be impressed by the argument that although such rules concededly would not have been violated by directing give-ups to a broker in reward for services having nothing to do with the particular transaction, a different result would be mandated when give-ups were obtained and applied by the adviser to reduce payments otherwise required from a fund. "We could not think it arbitrary," the court wrote, "in view of the common factors shared by these two kinds of rebates, for an exchange to say that the distinction did not compel a difference in result." For reasons indicated, we find the court's view quite understandable.

Against all this, reliance is placed on the SEC's 1972 statement, p. 1329 supra, that institutional "membership and practices which permit the rebate or recapture of commissions, directly or indirectly, should be eliminated." However, the SEC's statements do not explain why a practice which it had urged from 1966 to date had been an illegal rebate. We have been cited to nothing in the committee reports leading to enactment of the Securities Act Amendments of 1975 that would show any Congressional view that recapture under the rigid commission rate structure would have involved illegality. Congress simply decided that in the brave new world of negotiated rates, brokers serving the public should have the benefit of institutional business and that there was no need for institutional membership when the negotiated rate system would allow an institution to have its orders executed at charges that bore a reasonable relation to the services actually rendered.

By stipulating against fixed commission rates, the 1975 amendments eliminated the evil of payments to brokers in excess of the value of their services in executing orders of mutual fund advisers, which had led to give-ups that arguably constituted violations of the spirit of management

contracts and caused some advisers to recapture in an effort to achieve for their funds benefits that were properly theirs. Congress' decision that, with this accomplished, institutional exchange membership should be prohibited, implies no view that under the previous commission structure recapture was unlawful. The House committee which considered the 1975 amendments went to the heart of the matter when it said, H. R. Rep. No. 94-123, 94th Cong. 1st Sess., p. 57:

> The questions of competitive rates and institutional membership, while analytically distinct, are significantly related one to the other.

### VII. *Damages.*

In remanding to the district court for the determination of damages, we are bound to give such guidance as we can.

The first subject is the appropriate period. In *Moses* v. *Burgin, supra,* 445 F.2d at 385, the court held that "as a matter of law, in view of the PPI report" liability should attach no later than March 1, 1967, although the district court was left free to conclude in favor of an earlier date—presumably because of the suggestions made in that case by SEC staff as early as June, 1965 and repeated in September, 1966, see 445 F.2d at 377-78, 383. Since our record contains no similar facts (although there is some evidence that the Adviser knew of recapture efforts by other advisers as early as 1965), we hold that liability shall begin on March 1, 1967, thus allowing as did the First Circuit a reasonable period for consideration of and reaction to PPI.[30] Liability for failing to utilize NASD recapture in

30 This is subject to the caveat that plaintiffs may have failed to present more evidence that would support an earlier date because of the court's ruling in the pretrial order that liability would first be determined. Our opinion should not be read as precluding plaintiffs from endeavoring to develop any such evidence. See *Weiss* v. *Chaiker, supra,* 55 F.R.D. at 170-71.



respect of give-ups shall end on December 5, 1968, when these were abolished, and liability for failing to recapture through membership in the PBW Exchange shall end on March 29, 1973, the effective date of Rule 19b-2. While we see no reason to terminate liability for failing to recapture tender offer fees short of the day of judgment, the district court is free to consider this on the present or a supplemented record.

The amount for which defendants are to be held liable will depend on the attempt, difficult but ineluctable, of seeking to find what would have been. In deciding this we must mediate between the two principles, given expression in cases arising under the antitrust laws, that while "a defendant whose wrongful conduct has rendered difficult ascertainment of the precise damages suffered by the plaintiff, is not entitled to complain that they cannot be measured with the same exactness and precision as would otherwise be possible," *Eastman Kodak Co.* v. *Southern Photo Materials Co.,* 273 U.S. 359, 379 (1927),[31] yet recovery "cannot be had unless it is shown that, as a result of defendants' acts, damages in some amount susceptible of expression in figures resulted." *Keogh* v. *Chicago & Northwestern Ry.,* 260 U.S. 156, 165 (1922). The *Moses* court held the defendants (other than unaffiliated directors) liable for Crosby's failure to avail itself of NASD recapture (the only method there being pressed) on all transactions on the PBW and Pacific Coast Exchanges, since any lesser measure of recovery would mean that the business judgment defense, although foreclosed on the issue of liability because of lack of effective disclosure to unaffiliated directors, would be entering through the back door. In a footnote, 445 F.2d at 385 n.25, the court added that the

31 See also *Story Parchment Paper Co.* v. *Paterson Parchment Paper Co.,* 282 U.S. 555, 563 (1931); *Bigelow* v. *RKO Radio Pictures, Inc.,* 327 U.S. 251, 264-65 (1946).

district court "may well find that at a reasonable interval after a final determination to bank give-ups should have been made," during which interval the unfeasibility of achieving give-ups except on the PBW and Pacific Coast Exchanges might have been ascertained," proper practice would have been, consistent with best execution, to make as many transactions as possible on the two favorable exchanges." [32]

The *Moses* result may appear somewhat harsh, particularly in a case like this involving a medium-sized no-load fund where there were stronger business reasons against seeking recapture, at least for the period when reciprocals or give-ups to brokers in return for sales efforts were in vogue.[33] However, we think the considerations against allowing defendants to attempt to prove that, after independent investigation by the disinterested directors, the board might reasonably have concluded not to recapture, or at

32 It is not clear whether the court meant this diversion theory to apply only to the transfer of business from other regional exchanges or of business on NYSE as well. Although the former seems the probable construction, we see no reason why NYSE transactions in securities listed on the PBW or Pacific Coast Exchanges should be excluded from consideration of transfer simply because recapture was known to be unavailable on NYSE.

33 It is highly debatable whether an increase in the size of a mutual fund after attaining a certain magnitude is beneficial to the shareholders as distinguished from management. Since large blocks of securities cannot easily be assembled or sold without affecting the market, large funds are often unable to obtain as good a net price over as short a period of time as smaller funds. This restriction not only hampers the performance of a particular security; it also limits the range within which a large fund can choose portfolio securities. See PPI at 251-63. An open end fund like American Investors, however, does need to make sales equivalent to anticipated redemptions in order to avoid having to liquidate portfolio securities at disadvantageous times. For the Fund to have resorted to recapture, and particularly to have sought to maximize this, might have threatened its ability to make such sales in competition with other Funds which rewarded brokers with reciprocals or give-ups, often in addition to a considerable part of a sales load.



least not to go all out for recapture, see Part IV, *supra*, similarly foreclose defendants with respect to damages, as long as damages are limited to the business as actually conducted, namely, to tender fees and to those transactions carried out on the PBW and Pacific Coast Exchanges. On the other hand, if plaintiffs desire to pursue the path, noted in fn. 25 to *Moses*, of urging that the Adviser should have routed more of Fund's business to the PBW and Pacific Coast Exchanges, and of endeavoring to estimate what would have been recapturable if it had, compare *Weiss* v. *Chalker*, *supra*, 55 F.R.D. at 171, defendants should be allowed to develop the practical arguments against doing this, although not to relitigate the issues of possibility and legality of recapture. If this should seem a departure from strict logic, it would not be the first time this has occurred in the law of damages.

The judgment dismissing the action is reversed and the cause remanded for determination of damages.

## Statutory Appendix

Section 17(e), Investment Company Act of 1940, 15 U.S.C. § 80a-17(e)

"(e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—

(1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; or

(2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission."

Aug. 22, 1940, c. 686, Title I, § 17, 54 Stat. 815.





*Section 36, Investment Company Act of 1940, as amended in 1970, 15 U.S.C. § 80a-35:*

"(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

"(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments

of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.



(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or th security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this title for the purposes of sections 80a-9 and 80a-49 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for any injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section." (Aug. 22, 1940, ch. 686, title I, § 36, 54 Stat. 841; Dec. 14, 1970, Pub. L. 91-547, § 20, 84 Stat. 1428.)

*Section 36, Investment Company Act of 1940, 54 Stat. 841 (prior to 1970 amendments):*

"The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate." (Aug. 22, 1940, ch. 686, title I, § 36, 54 Stat. 841.)

Section 38(c), Investment Company Act of 1940, 15 U.S.C. § 80a-37(c)

"(c) No provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission,



be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.
Aug. 22, 1940, c. 686, Title I, § 38, 54 Stat. 841.

Section 11(a)(1) of the Securities Exchange Act of 1934, as amended in 1975, 15 U.S.C. § 78k(a)(1)

[Title as amended by Act of June 4, 1975 (Securities Acts Amendments of 1975), Sec. 6(1), 89 Stat. 110.]

Sec. 11. (a)(1) It shall be unlawful for any member of a national securities exchange to effect any transaction on such exchange for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion: Provided, however, That this paragraph shall not make unlawful—

(A) any transaction by a dealer acting in the capacity of market maker;

(B) any transaction for the account of an odd-lot dealer in a security in which he is so registered;

(C) any stablizing transaction effected in compliance with rules under section 10(b) of this title to facilitate a distribution of a security in which the member effecting such transaction is participating;

(D) any bona fide arbitrage transaction, any bona fide hedge transaction involving a long or short position in any equity security and a long or short position in a security entitling the holder to acquire or sell such equity security, or any risk arbitrage transaction in connection with a merger, acquisition,

tender offer, or similar transaction involving a recapitalization;

(E) any transaction for the account of a natural person, the estate of a natural person, or a trust (other than an investment company) created by a natural person for himself or another natural person;

(F) any transaction to offset a transaction made in error;

(G) any other transaction for a member's own account provided that (i) such member is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, or any one or more of such activities, and whose gross income normally is derived principally from such business and related activities and (ii) such transaction is effected in compliance with rules of the Commission which, as a minimum, assure that the transaction is not inconsistent with the maintenance of fair and orderly markets and yields priority, parity, and precedence in execution to orders for the account of persons who are not members or associated with members of the exchange; and

(H) any other transaction of a kind which the Commission, by rule, determines is consistent with the purpose of this paragraph, the protection of investors, and the maintenance of fair and orderly markets.